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SUPREME COURT, U. S.

TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1958

No. 360

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER,

vs.

JOHN R. HANSEN AND SHIRLEY G. HANSEN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR CERTIORARI FILED SEPTEMBER 16, 1958
CERTIORARI GRANTED NOVEMBER 10, 1958

No. 15821

United States Court of Appeals

for the Ninth Circuit

JOHN R. HANSEN and SHIRLEY G. HANSEN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Transcript of Record

Petition to Review a Decision of the Tax Court of the United States

Phillips & Van Orden Co., 4th & Berry, San Francisco, Calif.—1-31-58

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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NAMES AND ADDRESSES OF ATTORNEYS

For Petitioner:

EMMETT E. McINNIS, JR.,
900 Northern Life Tower,
Seattle 1, Washington.

For Respondent:

CHARLES K. RICE,
Assistant Attorney General,
Tax Division, Department of Justice,
Washington 25, D. C.

NELSON P. ROSE,
Chief Counsel, Internal Revenue Service,
Washington 25, D. C.

The Tax Court of the United States

Docket No. 62041

JOHN R. HANSEN and SHIRLEY G. HANSEN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1956

Apr. 26—Petition filed. Received 4/27/56. Taxpayer notified. Fee paid.

May 3—Copy of petition served on General Counsel. Served 5/3/56.

Apr. 26—Request for Circuit hearing in Seattle, Wash., filed by petitioner 5/2/56. Granted. Served 5/3/56.

May 29—Answer filed by respondent. Served June 4, 1956.

Nov. 19—Hearing set Feb. 4, 1957, Seattle, Wash.

1957

Feb. 11—Trial had before Judge Tietjens. Case submitted. Amended petition, answer to amended petition, Stipulation of Facts, Exhibits 1-A thru 5-E, filed at hearing. Briefs due 4/12/57; Replies due 5/2/57.

Feb. 26—Transcript of Hearing 2/11/57, filed.

Apr. 11—Motion for extension of time to 4/29/57, to file brief, filed by respondent. 4/12/57, Granted. Served 4/17/57.

1957

Apr. 15—Brief filed by petitioner.

Apr. 26—Brief filed by respondent. Served 4/29/57.

May 16—Reply Brief filed by respondent. Served 5/20/57.

May 20—Reply Brief filed by petitioner. Served 5/20/57.

June 28—Memorandum findings of fact and opinion rendered. Judge Tietjens. Decision will be entered under Rule 50. Served 6/28/57.

July 31—Agreed computation filed.

Aug. 1—Decision entered. Judge Tietjens. Div. 1. Served 8/5/57.

Nov. 4—Petition for Review by U. S. Court of Appeals, Ninth Circuit, filed by petitioner.

Nov 4—Notice of filing peition for review with proof of service thereon, filed.

Nov. 4—Statement of Points filed.

Nov. 4—Designation of contents of record on review with proof of service thereon, filed.

Nov. 4—Affidavit of service upon Respondent, filed.

Nov. 8—Designation of additional portions of record with statement of service, filed.

The Tax Court of the United States

Docket No. 62041

JOHN R. HANSEN and SHIRLEY G. HANSEN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

STIPULATION OF FACTS

It Is Hereby Stipulated and agreed between the parties to this proceeding, without prejudice to the right of either party to introduce other and further evidence not inconsistent herewith, as follows:

1. Petitioners are individuals, husband and wife, residing at 3001-122nd Place N. E., Bellevue, Washington. Their timely joint returns for the years here involved, 1951, 1952 and 1953, not including estimated returns, were filed with the Collector of Internal Revenue at Tacoma, Washington. The photostatic copies of said filed returns are attached hereto and may be introduced as Joint Exhibits 1-A, 2-B, and 3-C, respectively.

2. Timely Notice of Deficiency was mailed to the petitioners on January 27, 1956. Petitioners executed Consent on form 872, extending period for assessment of 1951 taxes to June 30, 1956. Photostatic copy of said consent is attached hereto, and may be introduced as Joint Exhibit 4-D.

3. Petitioner John R. Hansen is a Buick dealer, engaged in the business of selling automobiles in Bellevue, Washington, at retail. All of his sales upon time payments in the years 1951, 1952 and 1953, aside from any privately financed by the retail purchasers, were financed through General Motors Acceptance Corporation. A four-sheet form of Conditional Sale Contract and Assignment thereof was used on all such sales, without variation as to the printed form. A copy of said form is attached hereto, and may be introduced as Joint Exhibit 5-E.

4. The parties consent to the filing of Amended Petition and of Answer thereto. The parties stipulate that timely filing was made of the original Petition herein.

Dated this 11th day of February, 1957.

/s/ EMMETT E. McINNIS, JR.,
Counsel for Petitioners;

/s/ HERMAN T. REILING, W.H.P.
Bureau of Internal Revenue,
Counsel for Respondent.

[Endorsed]: Filed Feb. 11, 1957.

The Tax Court of the United States

Docket No. 62041

JOHN R. HANSEN and SHIRLEY G. HANSEN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

AMENDED PETITION

The above-named petitioners hereby petition for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his Notice of Deficiency dated January 27, 1956 (Associate Chief, Appellate Division, Internal Revenue Service, 123 U. S. Court House, Seattle 4, Washington, 901D), and claim certain refunds, and as a basis of their proceeding allege as follows:

1. The petitioners are individuals, husband and wife, residing at 3001-122nd Place N. E., Bellevue, Washington. The returns for the periods here involved were filed with the Collector of Internal Revenue for the district of Washington, at Tacoma, Washington.

2. The Notice of Deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioners on January 27, 1956.

3. The liabilities as determined by the Commissioner are deficiencies in income taxes for the calen-

dar years 1951, 1952, and 1953, aggregating $6,903.30; and penalties for the calendar years 1951, 1952 and 1953, aggregating $3,525.11. Detail is as follows:

Year	Deficiency	Section 294 (d)(1)(A) Penalty	Section 294 (d)(2) Penalty
1951	$1,092.66	$ 847.66	$ 565.10
1952	686.40	563.51	375.67
1953	5,124.24	703.91	469.26
Totals	$6,903.30	$2,115.08	$1,410.03

Petitioners dispute all deficiencies resulting from allocation of contingent liability reserve to income before release to petitioners; and dispute all of the penalties imposed.

Petitioners' corrected computations of income tax for 1951, 1952, and 1953 are attached and marked as Exhibits B, C, and D, respectively.

Petitioners claim refund of $341.43 for overpayment in 1951; refund of $957.70 for overpayment in 1952; and admit deficiency of $196.92 for 1953.

Year	Refund Claimed	Deficiency Admitted
1951	$341.43	—
1952	957.70	—
1953	—	$196.92

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) Error in allocation to income of petitioners; finance fees withheld by General Motors Acceptance Corporation in contingent liability reserve, in the

year in which the reserves were created by G.M.A.C., rather than in the year when released to petitioners, if ever released to petitioners at all.

This is the main issue. No other adjustment to income is in dispute. Petitioners claim that such erroneous allocation to income amounted to $3,154.29 for 1951; to $4,239.10 for 1952; and to $12,953.97 for 1953. The erroneous allocation in 1952 was made by petitioners' income tax return.

(b) Alternatively and without admission, if the Tax Court of the United States should hold that the aforesaid contingent liability reserve was income to petitioners when created rather than when released to petitioners, error in the Notice of Deficiency in allocating to income for 1953, reserves created in 1952 in the amount of $4,239.10.

(c) Error in imposing any penalties or portions of penalties, based upon the erroneous allocations to income set forth in subparagraphs 4(a) and 4(b) above.

(d) Error in imposing penalties for failure to file declaration of estimated tax, under section 294(d)(1)(A) of the Internal Revenue Code (1939): in the amounts of $847.66 for 1951, $563.51 for 1952, and $703.91 for 1953.

(e) Error in imposing penalties for substantial underestimation of declaration of estimated tax, under section 294(d)(2) of the Internal Revenue Code (1939): in the amounts of $565.10 for 1951, $375.67 for 1952, and $469.26 for 1953.

5. The facts upon which the petitioners rely as the basis of this proceeding are as follows:

(a) Petitioners are husband and wife, residing in a community property state, where the husband is a Buick dealer engaged in the business of selling automobiles at retail.

(b) Petitioners sell new autos upon conditional sales contracts. These are financed by the General Motors Acceptance Corporation, hereinafter referred to as G.M.A.C. The contract between petitioners and G.M.A.C. required that a contingent liability reserve, called "Dealer's Reserve," be withheld by G.M.A.C. out of the finance charges. This reserve was set at five per cent (5%) of the total amount of outstanding conditional sales contracts financed for petitioners' customers.

(c) The reserve was for the purpose of protecting G.M.A.C. from losses and to protect its prospect of profit. Losses from prepayment by auto purchasers and losses from repossessions were chargeable to the reserve. Losses from repossessions include losses from abnormal depreciation before repossession and losses from casualty not covered by insurance or by G.M.A.C. responsibility. Favorable collection experience was uncertain.

(d) The contingent liability reserve was held and controlled completely by G.M.A.C. At no time could the Petitioners draw at will upon the reserve, except when periodical audit showed an excess in reserve over 5% of total contracts financed. Favorable col-

lection experience was uncertain. Petitioners had no enforceable right to the money withheld. Receipt of it was beyond their control. There were substantial, concrete, restrictive conditions precedent.

(e) When petitioners did or could receive a payment from G.M.A.C.'s reserve, they declared it as income. The only funds in dispute here are those never received or receivable by Petitioners in the tax years in issue.

(f) Petitioners overpaid their income tax for 1951 by $341.43, and overpaid for 1952 by $957.70, as set forth in the attached Exhibits B and C, respectively. Petitioners admit income tax deficiency for 1953 of $196.92, as set forth in Exhibit D attached.

(g) Petitioners' failure to file declaration of estimated tax in 1951, 1952, and 1953 was under circumstances amounting to reasonable cause.

(h) Petitioner John R. Hansen is a businessman rather than an accountant or tax expert or attorney. Petitioner Shirley G. Hansen, his wife, was fully occupied with their home and children. Petitioner was concentrating all of his enegry and attention upon the building of his business, in a keenly competitive field. He was responsible for the most important decisions for his automobile dealership. He had to promote the sale of new and used cars; to appraise used cars and to approve all trade-ins; to hire and deal with employees; to supervise the repair and service departments and the auto parts

department; and to direct his advertising and public relations.

(i) Under these circumstances Petitioners delegated their bookkeeping and tax problems to others, during the tax years in issue. Those persons and petitioners were unaware of the statutory requirement of filing declaration of estimated tax.

(j) Petitioners filed their final returns for each of the tax years in issue, in a regular and consistent system of accounting and tax payment. They paid their tax in full each year as they had calculated it. The final form 1040 return for each year was such as to indicate to a tax expert that estimated returns should have been filed. But the regular and consistent mistake was never corrected. A telephone call or a form letter from the Internal Revenue Service would have enabled the taxpayers to avoid further violations. Petitioners believed in good faith that they were doing all that was required of them, by filing timely annual returns and paying their taxes each year.

(k) Petitioners did not make substantial underestimation of their declarations of estimated tax. Instead they failed to file any estimations at all, for which the Commissioner has assessed the distinct and explicit penalty for failure to file.

Wherefore, the Petitioners pray that this court may hear the proceeding and determine that:

1. Finance fees withheld by General Motors Acceptance Corporation in contingent liability reserve

became income to the petitioners when and if released to petitioners, and not when the contingent liability reserve was created by G.M.A.C.

2. Petitioners are entitled to judgment for refunds from respondent of $341.43 for 1951 and of $957.70 for 1952, with interest at the statutory rate.

3. Respondent is entitled to judgment for deficiency from petitioners of $196.92 for 1953, with interest at the statutory rate.

4. Alternatively, if finance fees withheld by General Motors Acceptance Corporation in contingent liability reserve, are held, to have become income to the petitioners when the reserve was created, the Notice of Deficiency erroneously allocated $4,239.10 of reserves which were created in 1952, to income for 1953; and to order correction by recomputation.

5. No penalty shall be assessed against Petitioners which is based upon erroneous allocations to petitioners' income.

6. Petitioners' failure to file declaration of estimated tax in 1951, 1952, and 1953 was under circumstances amounting to reasonable cause; and no penalty shall be assessed therefor.

7. Petitioners did not make substantial underestimation of declaration of estimated tax in 1951

nor in 1952 nor in 1953; and no penalty shall be assessed therefor;

and for such other and further relief as may be just and equitable in the premises.

/s/ EMMETT E. McINNIS, JR.,
Attorney for Petitioners.

State of Washington,
County of King—ss.

John R. Hansen and Shirley G. Hansen, being duly sworn, say that they are the petitioners above named; that they have read the foregoing petition, or had the same read to them, and are familiar with the statements contained therein, and that the statements therein are true, except those stated to be upon information and belief, and that those they believe to be true.

/s/ JOHN R. HANSEN,

/s/ SHIRLEY G. HANSEN.

Subscribed and sworn to before me this 31st day of January, 1957.

[Seal] /s/ A. W. RUDDELL,
Notary Public in and for the State of Washington.

EXHIBIT A

(Copy)

123 U. S. Court House,
Seattle 4, Washington

Ap:S:AA:90D
LEH:MHB

Mr. John R. Hansen and
Mrs. Shirley G. Hansen,
Husband and Wife,
Route 4, Box 147,
Kirkland, Washington.

Dear Mr. and Mrs. Hansen:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1951, December 31, 1952, and December 31, 1953, disclosed deficiencies in tax aggregating $6,903.30 and penalties aggregating $3,525.11 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency or deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia in which event that day is not counted as the 90th

day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Assistant Regional Commissioner, Appellate, 133 U. S. Court House, Seattle 4, Washington. The signing and filing of this form will expedite the closing of your case by permitting an early assessment of the deficiency or deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is the earlier.

Very truly yours,

RUSSELL C. HARRINGTON,
Commissioner,

By s/ JAMES E. WESTIN,
Associate Chief,
Appellate Division.

Enclosures:
Statement
Agreement Form
IRS Publication No. 160

LE:Henderson:MHB:EGG

Statement

Ap:S:AA:90D
LEH:MHB

Mr. John R. Hansen and Mrs. Shirley G. Hansen
Husband and Wife
Route 4, Box 149
Kirkland, Washington

Tax Liability for Taxable Years Ended December 31, 1951, December 31, 1952, and December 31, 1953

Income Tax

Year	Deficiency	Section 294 (d)(1)(A) Penalty	Section 294 (d)(2) Penalty
1951	$1,092.66	$ 847.66	$ 565.10
1952	686.40	563.51	375.67
1953	5,124.24	703.91	469.26
Totals	$6,903.30	$2,115.08	$1,410.03

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated November 30, 1954; to your protest dated April 20, 1955; and to the statements made at the conferences held on August 4 and September 2, 1955.

It has been determined that you are subject to the penalties for failure to file a declaration of estimated tax and for substantial understatement of estimated tax in each of the taxable years ended December 31, 1951, December 31, 1952, and December 31, 1953.

A copy of this letter and statement has been mailed to your representative, Mr. Dallas L. Carter, 618 Broadway North, Seattle, Washington, in accordance with the authority contained in the power of attorney executed by you.

Taxable Year Ended December 31, 1951
Adjustments to Net Income

Net income disclosed by return, Form 1040		$30,194.67
Unallowable deductions and additional income:		
(a) Finance reserve credit	$ 3,154.29	
(b) Depreciation	100.00	3,254.60
Total		$33,449.27
Nontaxable income and additional deductions:		
(c) Taxes		894.35
Net income adjusted		$32,554.92

Explanation of Adjustments

(a) It has been determined that the finance charge included in the gross sale price of an automobile is an intrinsic part of the selling price and includable in receipts in the year of the sale under your accrual method of accounting. Accordingly, the net $3,154.29 finance charges withheld by General Motors Acceptance Corporation under its retail financing plan represents a contingent reserve for possible losses, and does not constitute an allowable deduction in the computation of your taxable income. Your income is, therefore, increased by the above amount.

(b) The amount of $100.31, claimed in your return as depreciation on Chris Craft cruiser, is disallowed on the basis that it was not an ordinary and necessary business expense. Your business income is accordingly increased by this amount.

(c) It has been determined that you are entitled to a deduction in the amount of $1,265.80 for accrued real estate and personal property taxes. Since you claimed only $371.45 of this amount, your business income is reduced $894.35.

Computation of Tax

Net income adjusted	$32,554.92
Less: Exemptions	3,000.00
Balance	$29,554.92
One-half of balance	$14,777.46
Combined normal tax and surtax	$ 4,709.18
Total combined normal tax and surtax ($4,709.18 times 2)	$ 9,418.36
Self-employment tax	81.00
Income tax liability	$ 9,499.36
Liability disclosed by return, original Account No. BF 554	8,406.70
Deficiency	$ 1,092.66

Taxable Year Ended December 31, 1952

Adjustments to Net Income

Net income disclosed by return, Form 1040		$22,112.46
Unallowable deductions and additional income:		
(a) Depreciation	$ 1,253.08	
(b) Taxes	385.24	
(c) Contributions	400.00	2,038.32
Total		$24,150.78
Nontaxable income and additional deductions:		
(d) Capital gain		319.48
Net income adjusted		$23,831.30

Explanation of Adjustments.

(a) The total amount of $1,253.08, claimed in your return as depreciation and expense incurred in the operation of your Chris Craft cruiser, is disallowed on the basis that it was not an ordinary and necessary business expense. Your business income is accordingly increased by this amount.

(b) It has been determined that you overstated the deduction for accrued real estate and personal property taxes by $385.24. Your business income is increased by this amount.

(c) Your taxable net income is increased $400.00 to correct a mathematical error you made on your return in totaling the deduction for contributions paid.

(d) As a result of the disallowance of depreciation claimed on Chris Craft cruiser, the long-term capital gain resulting from the sale thereof has been determined to be $22.38, instead of $341.86, as reported in your return. Your taxable net income is, therefore, reduced $319.48.

Computation of Tax

Net income adjusted	$23,831.30
Less: Exemptions	3,000.00
Balance	$20,831.30
One-half of balance	$10,415.65
Combined normal tax and surtax	$ 3,130.57
Total combined normal tax and surtax ($3,130.57 times 2)	$ 6,261.14
Self-employment tax	81.00
Income tax liability	$ 6,342.14
Liability disclosed by return: Original, Account No. AF 708799	5,655.74
Deficiency	$ 686.40

Taxable Year Ended December 31, 1953
Adjustments to Net Income

Net income disclosed by return, Form 1040		$13,844.20
Unallowable deductions and additional income:		
(a) Finance reserve credit	$12,953.97	
(b) Taxes	248.30	
(c) Itemized deductions	1,430.75	14,633.02
Total		$28,477.22
Nontaxable income and additional deductions:		
(d) Standard deduction		1,000.00
Net income adjusted		$27,477.22

Explanation of Adjustments

(a) It has been determined that the finance charge included in the gross sale price of an automobile is an intrinsic part of the selling price and includable in receipts in the year of the sale under your accrual method of accounting. Accordingly, the net $12,953.97, finance charges withheld by General Motors Acceptance Corporation under its retail financing plan, represents a contingent reserve for possible losses, and does not constitute an allowable deduction in the computation of your taxable income. Your income is, therefore, increased by the above amount.

(b) It has been determined that you overstated the deduction for accrued real estate and personal property taxes by $248.30. Your business income is increased by this amount.

(c) and (d) Since your medical expenses do not exceed five per centum of the redetermined adjusted gross income, and the entertainment expense claimed as a miscellaneous deduction is a duplication of expenses on the company books, the deductions claimed therefor in the respective amounts of $321.25 and $387.50 are disallowed. The balance of itemized deductions in the amount of $722.00 is eliminated and, in lieu thereof, the standard deduction of $1,000.00 is allowed.

Computation of Tax

Net income adjusted	$27,477.22
Less: Exemptions	3,000.00
Balance	$24,477.22
One-half of balance	$12,238.61
Combined normal tax and surtax	$ 3,910.53
Total combined normal tax and surtax ($3,910.53 times 2)	$ 7,821.06
Self-employment tax	81.00
Income tax liability	$ 7,902.06
Liability disclosed by return, original Account No. ~~OF~~ 1039166	2,777.82
Deficiency	$ 5,124.24

EXHIBIT B

John R. and Shirley G. Hansen
Income Tax
Year Ending December 31, 1951

Adjustments:	
Net income disclosed by return, Form 1040	$30,194.67
Unallowable deductions—	
Depreciation	100.31
Total	$30,294.98
Nontaxable income and additional deductions:	
Taxes	894.35
Net income adjusted	$29,400.63

Tax Computation:	
Net income adjusted	$29,400.63
Less: Exemptions	3,000.00
Balance	$26,400.63
One-half of balance	$13,200.32
Combined normal and surtax	$ 7,984.27
Self-employment tax	81.00
Total tax	$ 8,065.27
Liability disclosed by return, original Account No. BF 554	8,406.70
Overpayment	$ 341.43

EXHIBIT C

John R. and Shirley G. Hansen
Income Tax
Year Ending December 31, 1952

Adjustments:		
Net income disclosed by return, Form 1040		$22,112.46
Less dealer's reserve accrued but not receivable in 1952, declared in error		4,239.10
Total		$17,873.36
Unallowable deductions:		
Depreciation	$ 1,253.08	
Taxes	385.24	
Contributions	400.00	2,038.32
Total		$19,911.68
Nontaxable income and additional deductions:		
Capital gain		319.48
Net income adjusted		$19,592.20

Tax Computation:	
Net income Adjusted	$19,592.20
Less: Exemptions	3,000.00
Balance	$16,592.20
Combined normal tax and surtax	$ 4,617.04
Self-employment tax	81.00
Income tax liability	$ 4,698.04
Liability disclosed by return	5,655.74
Overpayment	$ 957.70

EXHIBIT D

John R. and Shirley G. Hansen
Income Tax
Year Ending December 31, 1953

Adjustments:		
Net income disclosed by return; Form 1040		$13,844.20
Unallowable deductions:		
Taxes	$ 248.30	
Itemized deductions	1,430.75	1,679.05
Total		$15,523.25
Nontaxable income and additional deductions:		
Standard deduction		1,000.00
Net income adjusted		$14,523.25
Tax Computation:		
Net income adjusted		$14,523.25
Less: Exemptions		3,000.00
Balance		$11,523.25

One-half of balance	$ 5,761.63
Combined normal and surtax	$ 1,446.87
Combined normal and surtax, times 2	$ 2,893.74
Self-employment tax	81.00
Income tax liability	$ 2,974.74
Liability disclosed by return	2,777.82
Deficiency	$ 196.92

[Endorsed]: Filed Feb. 11, 1957.

[Title of Tax Court and Cause.]

ANSWER TO AMENDED PETITION

Comes Now the Commissioner of Internal Revenue, by his attorney, Herman T. Reiling, Acting Chief Counsel, Internal Revenue Service, and for his answer to the amended petition filed by the above petitioners, admits and denies as follows:

1. Admits the allegations of paragraph 1 of the amended petition.

2. Admits the allegations of paragraph 2 of the amended petition.

3. Admits the allegations of paragraph 3 of the amended petition.

4. (a) to (4) inclusive. Denies that respondent erred in his determination of deficiencies and penalties as shown by the notice of deficiency from which petitioners' appeal is taken. Specifically denies that he erred in the manner and form as alleged in para-

graphs 4 (a) to (e), inclusive, of the amended petition.

5. (a) Admits the allegations of paragraph 5 (a) of the amended petition.

(b) Denies the allegations of paragraph 5(b) of the amended petition, except that it is admitted that petitioners sell new automobiles upon conditional sales contracts.

(c), (d) and (e) Denies the allegations of paragraphs 5(c), (d) and (e) of the amended petition.

(f) Denies the allegations of paragraph 5(f) of the amended petition, except that it is admitted that there is an income tax deficiency for 1953 of at least $196.92.

(g) Admits the allegations of paragraph 5(g) of the amended petition, except it is denied that the failure to file was under circumstances amounting to reasonable cause.

(h) Denies the allegations of paragraph 5(h) of the amended petition, except it is admitted that petitioner John R. Hansen is a businessman and that Petitioner Shirley G. Hansen was occupied with their home and children.

(i) Denies the allegations of paragraph 5(i) of the amended petition.

(j) Denies the allegations of paragraph 5(j) of the amended petition, except it is admitted that petitioners filed their final return for each of the tax

years in issue and paid this tax in full each year as they had calculated it.

(k) Denies the allegations of paragraph 5(k) of the amended petition, except it is admitted that petitioner failed to file any estimations at all, for which the respondent has determined the distinct and explicit penalty for failure to file.

6. Denies generally each and every allegation of the amended petition not hereinabove specifically admitted, qualified or denied.

Wherefore, it is prayed that the Commissioner's determination be approved and the petitioners' appeal denied.

/s/ HERMAN T. REILING, W.H.P.
Acting Chief Counsel,
Internal Revenue Service.

Of Counsel:

MELVIN L. SEARS,
Regional Counsel;

WILFORD H. PAYNE,
Assistant Regional Counsel;

JOHN H. WELCH,
Special Attorney,
Internal Revenue Service.

[Endorsed]: Filed Feb. 11, 1957.

The Tax Court of the United States

Docket No. 62041

In the Matter of:

JOHN R. HANSEN, et al.,

Petitioner.

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

The above-entitled matter came on for hearing, pursuant to Notice, at 3:00 o'clock p.m.

Before the Honorable Norman O. Tietjens.

Appearances:

EMMETT E. McINNIS, JR.,
On Behalf of the Petitioner.

JOHN H. WELCH,
On Behalf of the Respondent.

JOHN R. HANSEN

called as a witness for and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

The Clerk: Will you state your name?

The Witness: John R. Hansen.

Direct Examination

By Mr. McInnis:

Q. State your address, please.

A. 3001 One Hundred Twenty-second Place Northeast.

Q. In Bellevue, Washington?

A. Bellevue, yes.

Q. What is your business, Mr. Hansen?

A. New car dealer.

Q. What make of car? A. Buick.

Q. Were you selling in 1951, 1952, and 1953 new automobiles on conditional sales contracts?

A. Yes.

Q. Calling to your attention Joint Exhibit 5(e), appendant to the stipulation of facts herein, is this the contract and form of contract which was used?

A. Yes.

Q. Was it used on all of the sales on credit made in that year? A. Yes.

Q. Were any such sales made by any other finance company [11*] than General Motors Acceptance Corporation in those years? A. No.

*Page numbering appearing at top of page of original Reporter's Transcript of Record.

(Testimony of John R. Hansen.)

Q. Can you tell us in some detail just what happened when a customer purchased a car upon credit from you in those years?

A. Well, we figured the cash price on the car, deducted his down payment and then computed what the finance cost would be on the unpaid balance and what the monthly payments would be, and in any event that the contract was paid up in advance he would get a rebate on the finance which would be charged both to my dealer reserve and to General Motors Acceptance Corporation.

Q. Was any part of that finance charge set aside as a contingent liability on their books?

Mr. Welch: I think that is objectionable. I don't think this witness is competent to testify what General Motors Acceptance Corporation does on their books.

Q. (By Mr. McInnis): Did you have a contract with General Motors Acceptance Corporation for this?

A. I believe I did, I signed up with them in 1948 and every year they come out with a manual and I give them a receipt for the manual.

Q. Was this contract a specific contract in writing or was it a general course of dealing between you as a dealer and General Motors Acceptance Corporation? [12]

A. I can't remember now if I did sign a contract at the outset when I first started in or not. That was 1948.

Q. Do you know of any such contract?

(Testimony of John R. Hansen.)

A. No, I can't honestly recall. As I said before, they give us a manual every so often and we sign a receipt for that. There is no signed contract.

Q. Does this contingent liability reserve vary in size?

A. Well, we have more reserve for the more outstanding we have, and as the outstanding goes down, well, they give us anything in excess of five per cent.

Q. Was it five per cent of outstanding conditional sales contracts in the three years at issue, 1951, 1952, and 1953? A. Yes.

Q. To your knowledge, as a party to this method of dealing this contract, what was the purpose of that contingent liability reserve?

A. Well, it was a reserve set up in case that I folded up it would protect the finance company to repossess; the cars would be worth less than what the contract calls for to pay back G.M.A.C. Also, in case of any prepayment on contracts, there would be a reserve there, then refund the customer part of the financing cost, which would be chargeable in direct proportion from what I received on the financing costs.

Q. Were there some prepayments by auto purchasers in [13] those three years?

A. Yes, there always is.

Q. Were there any losses during those three years from abnormal depreciation before repossession?

A. Yes, there was. Every time you repossess a car the only reason you really get it back is because

(Testimony of John R. Hansen.)

the car is worth less than what the man owes on it, otherwise he would take it and sell it for what he owes or more and keep the difference.

* * *

Q. (By Mr. McInnis): Were losses in all instances charged against the contingent liability reserve, to your knowledge? [14]

A. No, they weren't, they weren't all charged against the liability reserve.

Q. Were some charged and others charged on your own books as bad debts?

A. No, the only thing we ever charged off as bad debts on our own books are just bills that we couldn't collect and our accounts receivable. This didn't have anything to do with this reserve question at all.

Q. And your bad debts, then, had nothing to do, did they, with the credit sales of automobiles?

A. No.

Q. Who controlled the contingent liability reserve?

A. General Motors Acceptance Corporation.

Q. Could you draw upon it at your will?

A. No.

Q. If you had to have money, could you get it from the contingent liability reserve?

A. No, you can't borrow or draw anything other than the five per cent.

Q. Did you have any right to the money before it was released to you? A. No.

(Testimony of John R. Hansen.)

Q. When did you receive payments from the reserve? A. In my case I received it yearly.

Q. At what part of the year did you receive these payments? [15] A. January or February.

Q. And only how often during each year?

A. Once a year.

Q. Did you take these payments released to you when you could get them? A. Yes.

Q. Did you take all of them you could get?

A. Yes.

Q. When you did receive these payments, did you declare them as income? A. Yes. [16]

* * *

Q. Do you at the present time still work with General Motors Acceptance Corporation?

A. Yes, I do.

Q. Are you required to?

A. No, but I feel—no, we aren't required to.

Q. Were you required to during 1951, '52, and '53?

A. No, I wasn't required to. If I could have got a different connection, I probably would have used it.

Q. You were free to either hold these conditional sales contracts or assign them, depending on what you wanted to do? [20]

A. What do you mean "hold them"?

Q. Hold them personally, assuming you had sufficient cash, I am not saying that you did.

A. Yes, I could have held them if I had my own contracts made up.

(Testimony of John R. Hansen.)

The Court: You could have assigned them to some other finance company too, I suppose?

The Witness: Yes, if I had the connection, which I didn't. [21]

* * *

DALLAS L. CARTER

called as a witness for and on behalf of the Petitioners, having been first duly sworn, was examined and testified as follows:

The Clerk: Will you state your name, please?

The Witness: Dallas L. Carter.

Direct Examination

By Mr. McInnis:

Q. What is your address?

A. 32415 North, Seattle.

Q. And are you a certified public accountant?

A. I am.

Q. Do you hold a card for practice before the Treasury Department? [22]

A. I haven't had it renewed. I had a card which was issued to me in 1935 but I haven't had it renewed yet.

Q. Have you had any experience in accounting for automobile dealers?

A. Yes, considerable, since 1935 through the present time.

Q. For how many dealers are you doing the accounting now? A. Currently I have six.

(Testimony of Dallas L. Carter.)

Q. Have you been keeping the accounts for John R. Hansen and the Hansen Buick Company currently? A. Yes, I have.

Q. When did you assume those responsibilities?

A. According to my record I made Mr. Hansen's tax return up for the year 1953, although I think my engagement with him began in 1954, the early part of 1954. The engagement was to include the preparation of his 1953 tax return.

Q. Have you studied the accounting system which Mr. Hansen used in 1953? A. I have.

Q. And have you studied that which he used in 1951 and 1952? A. Yes.

Q. Did Mr. Hansen follow a regular and consistent theory of accounting in his bookkeeping in those years?

A. Yes, with the exception of 1952, at which time he deviated from his custom of deferring this dealer's reserve in [23] question, in 1952 he picked it all up, which is the inconsistency from the years, excluding 1952 he has followed a consistent practice.

Q. In the year 1952 was his accounting regular and consistent, excepting for the one inconsistency which you pointed out? A. Yes, it was.

Q. Will you describe the accounting entries to a sale on credit by the Petitioner during those three tax years?

A. The contract was discounted or sold to General Motors Acceptance Corporation. A certain sum of money was paid to Mr. Hansen which was not the face value of the contract. There was a certain per-

(Testimony of Dallas L. Carter.)

centage of each contract withheld, and I can only speak for the accounting methods used by Mr. Hansen. That amount withheld was debited to an account called "Due Finance Companies" and credited to an account called "Reserve for Repossession."

Q. If any of this reserve withheld by the finance company was made available to the Petitioner, what was the results in his account at that time?

A. It was picked up in his income at the time in which the money was received from the finance [24] company.

* * *

A. Mr. Hansen's books are kept on what is normally considered an accrual basis. Installment acconting, as I understand it, and generally accepted accounting procedure does not enter into this. Mr. Hansen's method of accounting, as I see it, to any extent the only question that would be considered in any way installment accounting would be the handling of the dealer's reserve and picking it up as the installments on the contracts are made to General Motors Acceptance, and then, in turn, at their discretion and decision, decide to let Mr. Hansen have that part of the reserve that they consider is payable.

Q. (By Mr. McInnis): Does that method of accounting treatment have your approval as a certified public accountant?

A. It is a generally accepted method of accounting which properly allocates the income to the year

(Testimony of Dallas L. Carter.)

in which it was earned, and I think it meets all the requirements of good accounting. [26]

* * *

Q. (By Mr. McInnis): To your knowledge were all sums released from the reserve reported as income? A. Yes.

Q. Were any deductions as bad debts taken on your client's books for the same loss which had been charged to the contingent liability reserve on the books of G.M.A.C.?

A. The only bad debts that appear on Mr. Hansen's book of [29] accounts and therefore in the tax returns are the bad debts returned on his open accounts receivable and not as a result of any repossession or any loss incurred in financing automobiles. According to his books and records they are the, entirely the result of sales on open account or parts, accessories, repairs, or other bits which incurred incidental to his business, they have nothing to do with the financing of automobiles. [30]

* * *

Q. In your opinion from study of these facts from the accountant viewpoint, do you consider this to have been a true reserve withheld?

A. Yes, I think that in the concept of the definition of reserve this is certainly a true reserve.

Q. Was there any constructive receipt of income?

A. No, there definitely was not in my opinion no constructive receipt of income until he was paid the

(Testimony of Dallas L. Carter.)

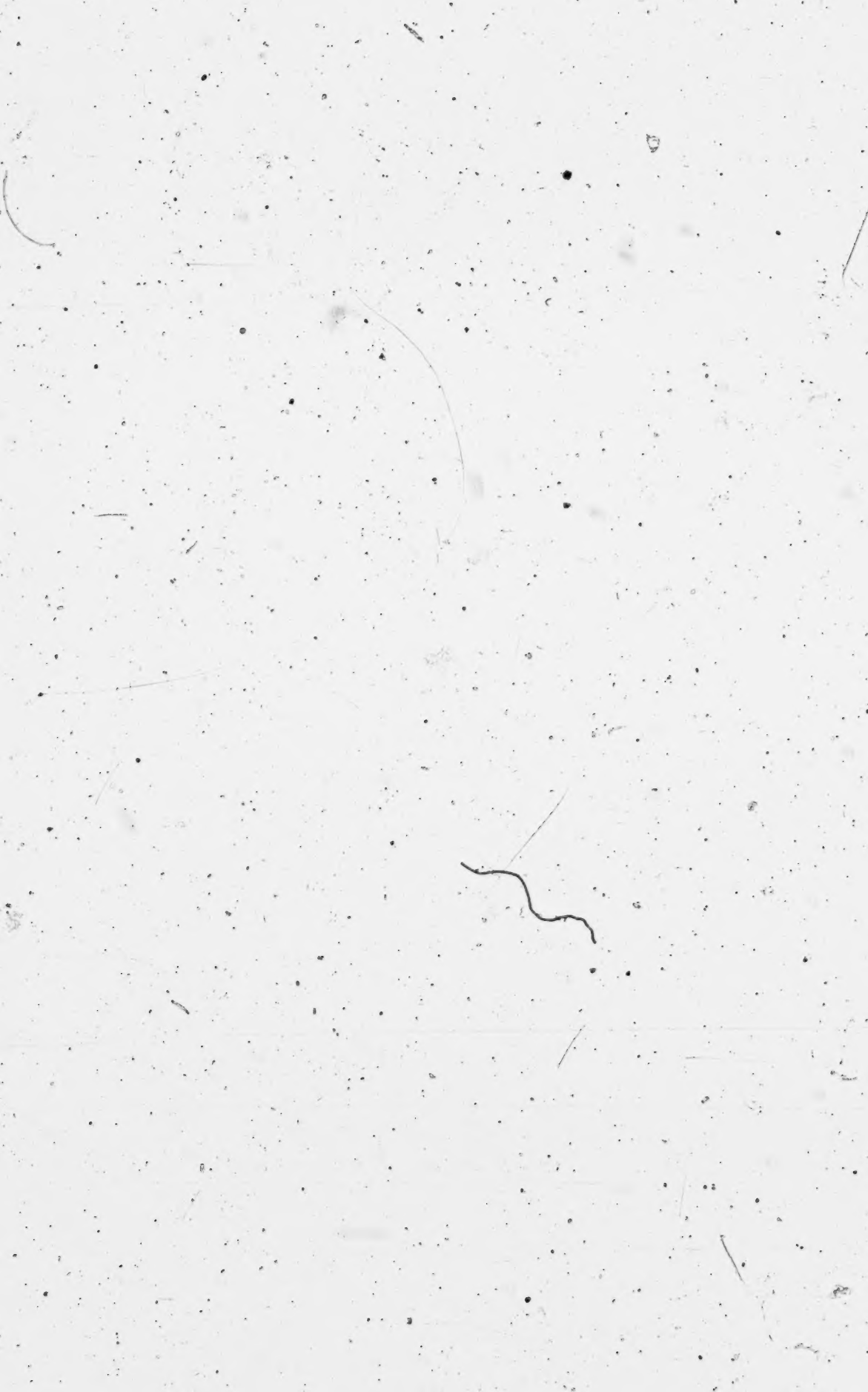
money. He had no access to it in any way until General Motors decided to pay it. He might have had many thousands of dollars and did have many thousands of dollars credited to this reserve, but as far as his ability to even borrow against it or receive it in any form, he had absolutely no privilege or recourse to it at all.

Q. When did such a right accrue to him?

A. When General Motors Acceptance sent him a check for the amount that they decided that he should have of that reserve. [31]

* * *

[Endorsed]: Filed Feb. 26, 1957.



Joint Exhibit No. 5-E

CONDITIONAL SALE CONTRACT

Contract Number _____

ORIGINAL

The undersigned seller hereby sells, and the undersigned purchaser or purchasers, jointly and severally, hereby purchase(s), subject to the terms and conditions hereinafter set forth, the following property, delivery and acceptance of which in good order are hereby acknowledged by purchaser, viz.:

New or Used	Year Model	No. Cyl.	Make Trade Name	Type of Body If Truck, Give Tonnage	Model Letter or Number	Manufacturer's Serial No.	Motor No.

For a TOTAL TIME PRICE (Sum of items 2 and 8) of: ..... $_____

Computed as follows:

1. CASH SALE DELIVERED PRICE (including accessories or extras, if any) ..... $_____
2. TOTAL DOWN PAYMENT under instalment sale ..... $_____
   Consisting of $_____ (Net Trade-In) plus $_____ (Cash)
3. DIFFERENCE BETWEEN ITEMS 1 AND 2 ..... $_____
4. COST OF REQUIRED CAR INSURANCE (include this item, if purchaser has authorized seller to apply for the insurance) ..... $_____
   Covering Accidental Physical Damage to the car as outlined below for the term indicated in the policy (check which applies).
   ☐ Comprehensive Coverage {including / excluding} $ _____ Deductible Collision.
   ☐ Fire-Theft and Additional Coverage {including / excluding} $ _____ Deductible Collision.
   Insurance settlement shall be based upon actual value of property at time of loss, not to exceed limits of liability set forth in the policy, and shall be payable to purchaser, seller or seller's assignee, as interests may appear.
5. OTHER CHARGES, if any ..... $_____
   Describe _____
6. PRINCIPAL BALANCE (Add items 3, 4 and 5) ..... $_____
7. FINANCE CHARGE (Including Charge for Group Creditor Insurance $ _____) ..... $_____
8. TIME (DEFERRED) BALANCE (Add items 6 and 7) ..... $_____
   Payable at office of General Motors Acceptance Corporation to be hereafter designated in _____ instalments of ..... $_____
   each, commencing _____, 19 ___ and on the same day of each successive month, or as indicated in the space below. The final instalment shall equal the amount of time balance remaining due.

.....

.....

.....

The Purchaser understands and agrees that the provisions on the reverse side hereof, hereby incorporated by reference, constitute a part of this contract.

Executed in quadruplicate, copy of which was delivered to and retained by purchaser, this _____ day of _____, 19___.

(Do not date on Sunday)

each, commencing _____, 19 ___ and on the same day of each successive month, or as indicated in the space below. The final instalment shall equal the amount of time balance remaining due.

_____

_____

_____

The Purchaser understands and agrees that the provisions on the reverse side hereof, hereby incorporated by reference, constitute a part of this contract.

Executed in quadruplicate, copy of which was delivered to and retained by purchaser, this _____ day of _____, 19 ___

(Do not date on Sunday)

In the event this contract is executed by more than one person as purchasers, it is understood and agreed that the person upon whose life insurance will be procured is and shall be the FIRST of the undersigned purchasers.

Purchaser Signs ☛ _____ _____

(Street) (Town) (Postal Zone) (State)

Co-Purchaser Signs _____ _____

(Street) (Town) (Postal Zone) (State)

Seller Signs ☛ _____ _____

(Street) (Town) (Postal Zone) (State)

By _____

(If Corp. or Partnership) (Title)

_____ [SIGN IN INK] _____

(Witness) (Witness)

Dealers' Recommendation, Assignment and Guaranty

For value received, undersigned does hereby sell, assign and transfer to the General Motors Acceptance Corporation his, its or their right, title and interest in and to the within contract, herewith submitted for purchase by it, and the property covered thereby and authorizes said General Motors Acceptance Corporation to do every act and thing necessary to collect and discharge the same.

The undersigned certifies that said contract arose from the sale of the within described property, warranting that title to said property was at time of sale and is now vested in the undersigned free of all liens and encumbrances; that said property is as represented to the purchaser of said property by the undersigned and that statements made by the purchaser of said property on the statement form attached hereto are true to the best of the knowledge and belief of the undersigned.

In consideration of your purchase of the within contract, undersigned guarantees payment of the full amount remaining unpaid hereon, and convenants if default be made in payment of any instalment herein to pay the full amount then unpaid to General Motors Acceptance Corporation upon demand, except as otherwise provided by the terms of the present General Motors Acceptance Corporation Retail Plan. Liability of the undersigned shall not be affected by any indulgence, compromise, settlement, extensions or variation of terms of the within contract effected with, or by the discharge or release of the obligation of the purchaser or any other person interested, by operation of law or otherwise. Undersigned waives notice of acceptance of this guaranty and notices of non-payment and non-performance.

Seller Signs ☛ _____ _____ By _____

(Seller's Signature) (If Corp. or Part.) (Title)

(For use in State of Washington only)

Provisions

1. For the purpose of securing payment of the obligation hereunder, seller reserves title, and shall have a security interest, in said property until said amount is fully paid in cash. No transfer, renewal, extension or assignment of this contract or any interest thereunder, and no loss, damage or destruction of said property, shall release purchaser from his obligation hereunder. In the event of the transfer and assignment of seller's rights hereunder, the word "seller" shall be understood as referring to the subsequent holder of this contract under such transfer and assignment, except as may be otherwise particularly stated herein. Purchaser shall keep said property free of all taxes, liens and encumbrances, and any sum of money that may be paid by seller in release or discharge thereof shall be paid on demand as an additional part of the obligation secured hereunder. Purchaser shall not use said property illegally, improperly or for hire; and shall not, without express permission of seller, remove said property from the state or transfer or otherwise dispose of any interest in this contract or said property.

2. (a) In the event that the time price payable hereunder does not include a charge for the above described required car insurance, the purchaser shall furnish to the seller upon request satisfactory evidence of said insurance. Upon failure of the purchaser to do so for any reason, the seller may, but without prejudice to seller's rights under this contract if it does not, endeavor to procure such insurance, and in the event that the seller does procure same the purchaser agrees to pay the premium therefor upon demand, as an additional part of the obligation secured hereunder.

(b) Proceeds of the aforesaid required car insurance, by whomsoever procured, shall be applied toward replacement of the property or payment of this obligation, at the option of the seller.

(c) In the event that the obligation payable hereunder does include a charge for the above-described car insurance protecting all interests hereunder and that (1) the insurance company to which the seller is authorized to apply therefor refuses to issue such insurance or (2) subsequent to issuance thereof and during the term of this contract such insurance is cancelled, the seller shall apply either an amount equal to the aforesaid insurance charge in the case of (1) above, or in the case of (2) above an amount equal to the unearned portion of the premium for such insurance upon seller's receipt therefrom the insurer pursuant to authorization hereby given therefor, as a credit in reduction of that portion of the unpaid balance which comprises so much of one or more of the instalments payable on the latest due dates (including the final due date) hereunder as equals the amount herewith provided to be applied, it being understood and agreed that the order of applying said amount to said instalments shall be inverse to the order in which they are payable hereunder.

3. Time is of the essence of this contract. Any instalment [illegible] said property may be and remove same, and may hold temporarily any other property in the above described motor vehicle at the time of repossession, wherever such other property may be therein, for the purchaser without liability on the part of the seller; thereupon any and all rights and interests of the purchaser to and in said property shall terminate, and the seller shall retain all payments made by the purchaser hereunder as liquidated damages; or (b) declare the unpaid balance, together with any other amount for which the purchaser shall have become obligated hereunder, to be immediately due and payable, and in that event the seller shall have the right to sue for and collect, and the purchaser shall pay, the amount due with interest.

5. The seller's acceptance of any instalment or payment after it or the full amount may have become due and payable hereunder shall not be deemed to alter or affect, the purchaser's obligations and/or the seller's rights hereunder with respect to any subsequent payments or default therein.

6. No representations, promises or statements have been made by seller unless endorsed hereon in writing. No modification of any of the terms or conditions hereof shall be valid in any event, and the purchaser expressly waives the right to rely thereon, unless made in writing duly executed by the seller.

7. The purchaser hereby specifically requests and authorizes the seller or assignee, in its or their own name, to procure from the Prudential Insurance Company of America insurance against the contingency of the purchaser's death occurring prior to the 15th day after the date herein provided for payment of the final instalment hereunder, such insurance to terminate automatically prior thereto at the earliest of the following dates: (1) the date on which the unpaid balance of the obligation hereunder is fully paid, in the event of prepayment thereof; (2) the 90th day after continued default by the purchaser in any payment when due hereunder unless the property is repossessed during such 90-day period; (3) in the event of repossession of said property on or before the 90th day after default, then on the 15th day after such repossession, unless during said 15-day period the purchaser redeems the repossessed property and this contract is reinstated. Such insurance shall be payable to the seller or assignee, or both, in an amount equal to the balance remaining to be paid hereunder on the happening of such contingency prior to termination of the insurance; provided, however, that the amount of insurance shall not exceed $3500 notwithstanding that the balance then remaining to be paid hereunder may be in excess of said maximum amount. If and when received, the proceeds of said insurance shall be applied in payment of the obligation under this contract to the extent of such proceeds, provided, however, that in the event the purchaser has prior hereto incurred instalment obligations under other contracts containing the same pro-

agree-

from the insurer pursuant to authorization hereby given therefor, as a credit in reduction of that portion of the unpaid balance which comprises so much of one or more of the instalments payable on the latest due dates (including the final due date) hereunder as equals the amount herewith provided to be applied, it being understood and agreed that the order of applying said amount to said instalments shall be inverse to the order in which they are payable hereunder.

3. Time is of the essence of this contract. Any instalment or amount payable hereunder, if unpaid five (5) days after it becomes due, shall include interest thereon at the highest lawful contract rate from the due date. In the event that any instalment shall not have been paid within thirty (30) days after it becomes due and payable, the purchaser expressly acquiesces in the right of the holder of this contract to delegate a representative to endeavor in person to collect such unpaid instalment and, in acknowledgment thereof, the purchaser hereby agrees to pay a further charge in a sum equal to five per cent (5%) of such unpaid instalment, but such charge shall neither be less than one dollar nor exceed five dollars in any event. The purchaser agrees, in the event this contract is placed in the hands of an attorney for collection, to pay fifteen per cent (15%) of the amount due or such lesser sum as may be permitted by law, as attorney's fees.

4. In the event the purchaser defaults in any payment or fails to comply with any of the conditions or terms of this contract, or a proceeding in bankruptcy, receivership or insolvency be instituted by or against the purchaser or his property, or the seller deems the property in danger of misuse, confiscation or destruction, or in the event either that the purchaser fails for any reason to comply with paragraph 2 (a) above or that said required car insurance (whether procured by the seller or by the purchaser), is cancelled by the insurer prior to expiration thereof, then the seller may, at his or its option, either (a) take immediate possession of said property, including any equipment or accessories thereto, without demand and with or without process of law and for this purpose the seller may enter upon the premises where

ing to be paid hereunder on the happening of such contingency prior to termination of the insurance; provided, however, that the amount of insurance shall not exceed $3500 notwithstanding that the balance then remaining to be paid hereunder may be in excess of said maximum amount. If and when received, the proceeds of said insurance shall be applied in payment of the obligation under this contract to the extent of such proceeds, provided, however, that in the event the purchaser has prior hereto incurred instalment obligations under other contracts containing the same provisions for insurance on his life and the aggregat of the amount of insurance otherwise payable pursuant to the aforesaid provisions of this contract and each of said other contracts exceeds the sum of $10,000, the aggregate of insurance to the benefits of which the purchaser may become entitled under all of said contracts, including this one, shall be limited to the sum of $10,000, and in such case the amount to be applied to payment of the obligation under this contract shall be the balance, if any, remaining after said aggregate insurance proceeds in the sum of $10,000 have been applied to payment of the instalment obligation or the aforesaid maximum amount of insurance, whichever is the lesser, under each of said other contracts. In consideration of the foregoing, the purchaser waives, and releases the seller or assignee from, any and all claims to all such rights, benefits or advantages as may accrue under such insurance. The time price payable under this contract includes a charge for said insurance. In the event that the seller is unable, for any reason, to procure such insurance or other similar insurance at a cost equal to the amount of said charge, the seller shall forthwith notify the purchaser to that effect, whereupon the time balance payable under this contract shall be reduced by the amount of said charge and the purchaser shall be credited with payment thereof.

8. Any provision of this contract prohibited by law of any state shall as to such state be ineffective to the extent of such prohibition without invalidating the remaining provisions of the contract.

Personal Guaranty by Third Party

In consideration of the making of the within contract by the dealer therein, the undersigned does hereby guarantee to said dealer, or any assignee of said contract, payment of all deferred payments as specified therein and covenants in default of payment of any instalment or performance of any requirement thereof by purchaser to pay full amount remaining unpaid upon demand. The liability of the undersigned shall not be affected by any settlement, extensions, variation of terms of the within contract effected with, or by the discharge or release of the obligation of the purchaser or any other person interested, by operation of law or otherwise.

Notice of acceptance of this guaranty, notices of non-payment and non-performance, notices of amount of indebtedness outstanding at any time, protests, demands, and prosecution of collection, foreclosure and possessory remedies, and the right to remove any legal action from the court originally acquiring jurisdiction, are hereby expressly waived.

(Witness) (Guarantor)

(Address)

[Title of Tax Court and Cause.]

BRIEF FOR PETITIONERS

Taxes and Penalties in Controversy

The taxes in controversy are income taxes for the calendar years 1951, 1952 and 1953; and penalties imposed for the same years for failure to file declarations of estimated tax and for substantial underestimation of declarations of estimated tax.

The liabilities as asserted by the Commissioner are as follows:

Year	Deficiency	Section 294 (d)(1)(A) Penalty	Section 294 (d)(2) Penalty
1951	$1,092.66	$ 847.66	$ 565.10
1952	686.40	563.51	375.67
1953	5,124.24	703.91	469.26
Totals	$6,903.30	$2,115.08	$1,410.03

The taxpayers petition for redetermination, claim refund and admit deficiency as follows:

Year	Refund Claimed	Deficiency Admitted
1951	$341.43	—
1952	957.70	—
1953	—	$196.92

The taxpayers dispute all of the penalties imposed.

Issues to be Decided

1. Did finance fees withheld in contingent liability reserve by G.M.A.C. accrue as income to autodealer petitioners in the year when the reserves were created by G.M.A.C., or in the year when re-

leased to petitioners, if ever released at all? This is the main issue.

2. Was there reasonable cause for the failure of petitioners to file declarations of estimated tax, in 1951, 1952 and 1953?

3. Does petitioners' failure to file declaration of estimated tax in 1951, 1952 and 1953 incur the distinct penalty for substantial underestimation of declaration of estimated tax?

4. Has the Commissioner's Notice of Deficiency erroneously allocated to income for both 1952 and 1953 the same reserve created in 1952 and released in 1953, in the amount of $4,462.27?

Statement of Facts

1. Petitioners are husband and wife, residing in a community-property state, where the husband is a Buick dealer engaged in the business of selling automobiles at retail. (Alleged, par. 5(a), Am. Petition; admitted, par. 5(a) Answer thereto.)

2. Petitioners sell new autos upon conditional sales contracts. (Adm., par. 5(b) Answer.)

3. All of petitioners' sales on credit in the tax years at issue were made upon the same G.M.A.C. form of conditional sales contract, Joint Exhibit 5-E, and all were financed by General Motors Acceptance Corporation. (Tr. 11, 12; Strip. par. 3.)

4. The conditional sales contracts were payable by the retail purchaser at the office of General Mo-

tors Acceptance Corporation. [Joint Exhibit 5-E, pg. 1 (8).]

5. Petitioners in fact held none of the conditional sales contracts for financing by petitioners, and financed none of them through any finance company other than G.M.A.C. (Tr. 21, 24.)

6. The course of dealing between petitioners and G.M.A.C. required that a contingent liability reserve, called "Dealer's Reserve," be withheld by G.M.A.C. out of the finance charges. (Tr. 12, 13.)

7. The pattern of petitioners' financing of credit sales was a single transaction: The retail purchaser signed the conditional sales contract on the same form, petitioners assigned the contract to G.M.A.C. by the same form for assignment on the face of the contract, and delivered it to G.M.A.C. in return for money. (Tr. 11, 12, 24, 31; Joint Exhibit 5-E).

8. The amount of the contingent liability reserve was set at five per cent of the total amount of conditional sales contracts outstanding with G.M.A.C. for petitioners' customers. (Tr. 13).

9. The purpose of the reserve was to protect G.M.A.C. from losses. Losses from prepayment by auto purchasers and losses from abnormal depreciation before repossessions were chargeable to the reserve. (Tr. 13).

10. The reserve was withheld and controlled completely by G.M.A.C. (Tr. 15).

11. Petitioners could not draw upon the contingent liability reserve at will; could not borrow against it; and had no right to any of the reserve until release by G.M.A.C. (Tr. 15, 31).

12. Release of any reserve was contingent upon an excess over five per cent of outstanding contracts. (Tr. 13).

13. Losses chargeable to contingent liability reserve did occur, prepayments and abnormal depreciations before repossession. (Tr. 14).

14. Petitioners withdrew funds released to them when they could get them, and took all they could get. (Tr. 16, 24).

15. All payments actually received by petitioners from G.M.A.C., including funds released from contingent liability reserve, were reported as income in the years in which received. (Tr. 16, 21, 24, 29).

16. Petitioners did not charge losses already charged by G.M.A.C. against the contingent liability reserve, against bad debts. Petitioners' bad debts account had nothing to do with the sale of autos on credit. (Tr. 15, 29, 30).

17. Petitioners' accounts followed a regular and consistent theory of accounting in 1951, 1952 and 1953, excepting only that all contingent liability reserves created by G.M.A.C. in 1952 were picked up as income in 1952. (Tr. 23, 24, 26).

18. Petitioners' accounting was upon the accrual basis. (Tr. 26).

19. Respondent's Notice of Deficiency erroneously allocated to income for both 1952 and 1953, the same reserve created in 1952 and released to petitioners in 1953, in the amount of $4,462.27. (Conceded, Tr. 34).

* * *

Argument

I.

Finance Fees Withheld in Contingent Liability Reserve by G.M.A.C. Accrued as Income to Auto-Dealer Petitioners in the Year When Released to Petitioners, and Not in the Year When Created as Reserve by G.M.A.C.

The only funds in issue here are those withheld by G.M.A.C. in its contingent liability reserve, and not released to petitioners in the tax years. Where there was an excess of reserve over 5 per cent of outstanding contracts financed for petitioners, the excess was released by G.M.A.C. annually. Petitioners withdrew funds released to them when they could get them, and took all they could get. Petitioners have declared every such payment received.

Petitioners had no actual receipt of the funds in issue, as income. Each conditional sales contract provided for the time payments to be made at the office of G.M.A.C. No time payments were made to petitioners. Each contract was assigned by petitioners to G.M.A.C. upon execution. The consideration paid to petitioners by G.M.A.C. was taken up and declared by petitioners as income, and is not in issue.

Petitioners used the same finance company to finance every credit sale during the three tax years in issue, without exception. They used the same conditional sales contract and assignment form. As the United States Court of Appeals, Fourth Circuit, said in Blaine Johnson v. Commissioner of Internal Revenue (1956) 233 F. 2d 952, at 957, "The pattern of each sale was a single transaction from the time the trailer was sold through the time the note was discounted by the particular finance company on whose forms it was executed."

Petitioners had no constructive receipt of the funds in issue, as income. Regulation 118, s. 39.42-2, sets forth the doctrine of constructive receipt. It provides that income may be taxed prior to the year of actual receipt although not then actually reduced to possession, if: (1) it is credited to the account of or set apart for the taxpayer, and (2) it may be drawn upon by the taxpayer at any time.

> "To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition * * *" Reg. 118, s. 39.42-2.

The plain fact is that the reserve withheld by G.M.A.C. could not be "drawn upon by petitioners

at any time." There could be no payment to petitioners at all unless the reserve exceeded 5 per cent of total outstanding contracts financed for petitioners; and then payment was limited to the excess, without invasion of the 5 per cent reserved which the Commissioner has allocated to income.

There were substantial, concrete, restrictive conditions precedent. Any payment to petitioners was contingent upon an excess, which could result only if G.M.A.C. had favorable experience in collections upon the contracts from customers of petitioners. Favorable experience was uncertain, because losses from prepayments by auto purchasers were chargeable to the reserve, as were losses for abnormal depreciation before repossession. The testimony establishes that there always were such losses. Because of losses to be charged to the reserve, the ultimate receipts from it by petitioners were not determinable at the dates of creation of reserve.

G.M.A.C. retained control of the contingent liability reserve. Petitioners had no enforceable right to the funds in issue. Neither bankruptcy nor starvation would have given petitioners a legal right to reach the reserve. It was a true reserve, with specific conditions precedent and definite contingencies, in the control of a party dealing at arm's length with petitioners.

The United States Circuit Court of Appeals for the Third Circuit decided the present issue in 1944, in Keasbey & Mattison Co. vs. United States, 141 F.

(2d) 163. The taxpayer was a manufacturer of asbestos products who arranged with a finance company to discount notes given by purchasers to retailers of its products. Under its contract with the finance company the taxpayer guaranteed part of the notes. Part of the discount was to be retained by the finance company in a reserve account, analogous to G.M.A.C.'s reserve, to cover the guaranty. Circuit Judges Biggs, Jones and Goodrich unanimously held that the amount of the reserve was not income to the taxpayer so long as the right to any of it was uncertain. This decision was never appealed by the United States. The Keasbey & Mattison case involves the same principles as the Hansen case, and is directly in point.

The United States Court of Appeals for the Fourth Circuit decided the present issue in Blaine Johnson v. Commissioner of Internal Revenue (1956) (233 F. 2d 952. The taxpayers were dealers in trailers, who financed credit sales by endorsing purchasers' promissory notes over to banks and to a finance company. A variable reserve was withheld from the taxpayers by the bank or finance company.

The Court held that the reserves withheld were not taxable income to the taxpayer in the years in which accredited as reserves, but rather in the years in which they became payable to taxpayers.

The Court said:

> "The general principles which must control our decision have been authoritatively stated

by the Supreme Court. It is 'the right to receive and not the actual receipt' of an amount which determines its accruability. 'When the right to receive an amount becomes fixed, the right accrues.' Spring City Foundry Co. v. Commissioner, 292, U.S. 182, 184 185, 54 S. Ct. 644, 645, 78 L. Ed. 1200. Until the right to an amount becomes accruable through fixation of the right to receive, the taxpayer is under no obligation to return it as income. Otherwise he would be required to pay a tax on income which he might never have a right to receive. North American Oil Consolidated v. Burnet, 286 U.S. 417; 423-424, 52 S. Ct. 613, 76 L. Ed. 1197." Blaine Johnson v. Commissioner of Internal Revenue (1956) 233 F. 2d 952, at 956.

In the case of Commissioner of Internal Revenue v. Cleveland Trinity Paving Co. (1932) 62 F. 2d 85, the Circuit Court of Appeals for the Sixth Circuit reached the same result, in principle. It held that, under a paving contract, percentages retained to guarantee maintenance of pavement were taxable as income to the contractor in the years when the money was paid, rather than in the years when the contracts were completed except as to maintenance. The Court noted "the further principle that the fact that the taxpayer kept its books in most respects upon the accrual basis does not require it to accrue that which is but contingently earned." Commissioner of Internal Revenue v. Cleveland Trinity Paving Co. (1932) 62 F. 2d 85. The Commissioner did not appeal.

Upon the foregoing grounds and authorities, petitioners submit that the funds in issue became income to petitioners only when and if made available to them, i.e., when released to petitioners by G.M.A.C.

* * *

III.

Failure to File Declarations of Estimated Tax in 1951, 1952 and 1953, Does Not Incur the Distinct Penalty for Substantial Underestimation of Declarations.

Petitioners appeal from the penalties imposed for substantial underestimation, on grounds that there was no underestimation but rather a failure to file any estimation at all, for which the distinct and explicit penalty for failure to file has been assessed.

The Code provided, for 1951, 1952 and 1953, as follows:

> "Substantial underestimate of estimated tax. If 80 per centum of the tax * * * in the case of individuals other than farmers * * * exceeds the estimated tax * * * there shall be added to the tax an amount equal to such excess, or equal to 6 per centum of the amount by which such tax so determined exceeds the estimated tax so increased, whichever is the lesser * * *". Internal Revenue Code (1939) sec. 294(d)(2).

The United States District Court for the Northern District of Georgia, decided this point in 1954 in the case of U. S. v. Ridley, 120 F. Supp. 530, at page 538:

"The addition of 10% of the tax for failure to file the declaration or to pay the installment of the estimated tax is proper to be added in the appropriate years. However, the addition of 6% for substantial underestimate of estimated tax is improper for the very obvious reason that the tax was not underestimated, indeed, the taxpayer filed no declaration of estimated tax at all and suffers the greater sanction of 10% addition to the tax for the failure, and the failure to pay the tax.

"The argument of the government that the failure to file the declaration of estimated tax is in effect a declaration of no tax, thus subjecting the taxpayer to this penalty, is rejected as contrary to a proper construction of the statutes."

The Ridley decision has not been appealed by the government. The earlier case of G. E. Fuller, 20 T.C. 308, decided in May, 1953, is contra. It was affirmed on other issue at 213 F. (2d) 102; but the present issue was not considered upon appeal.

Owen v. United States, D.C.D. Nebraska (1955) 134 F. Supp. 31, supports the Ridley decision and petitioners' position. Taxpayer was held not subject to penalty for substantial underestimate, although he was subject to greater penalty for failure to file estimate.

The legislative intent was to impose only a single civil penalty for failure to file declarations without reasonable cause. There are two separate and dis-

tinct penalties in the law, 6 per cent for substantial underestimate and 10 per cent for failure to estimate at all. If the penalty for failure to file were intended to be 16 per cent instead of 10 per cent, Congress would have made it 16 per cent.

The legislative intent to impose only a single penalty for failure to file was demonstrated in the Internal Revenue Code of 1954. The separate penalty for failure to file declarations of estimated tax was removed, I.R.C. (1954) sec. 6651 (*c*); and a single penalty of 6 per cent per annum was imposed for failure to pay estimated tax, whether declaration was filed or not. I.R.C. (1954) sec. 6654.

As a matter of law, petitioners submit that the penalty for substantial underestimation cannot properly be imposed for petitioners' failure to file declarations of estimated tax in 1951, 1952 and 1953.

Conclusion

Petitioners submit that the finance fees withheld from them by G.M.A.C. in a reserve which they could not possibly reach, were not income to petitioners until released to them from that reserve; that there was reasonable cause for petitioners' failure to file declarations of estimated tax for the years at issue; that the penalty for substantial underestimation was not incurred by the failure to file declarations of estimated tax; and that the same amount of $4,462.27 was erroneously allocated to

income for both 1952 and 1953, in petitioners' returns and in respondent's Notice of Deficiency. Wherefore petitioners pray that respondent's determination be held erroneous and be reversed by this Court.

/s/ EMMETT E. McINNIS, JR.,
Attorney for Petitioners.

[Endorsed]: Filed April 15, 1957.

[Title of Tax Court and Cause.]

REPLY BRIEF FOR PETITIONERS

Preliminary Statement

Petitioners' brief has heretofore been filed. Petitioners have been given until May 20, 1957, to file a reply to respondent's brief.

Argument

I.

What G.M.A.C. Paid Petitioners When Each Contract Was Assigned Was Not the Full or Face Amount of the Contract.

On page 5 of his opening brief, respondent requests a finding that petitioners assigned their contracts "in exchange for the amount set forth in the contract, but reduced by an amount withheld and placed in a reserve account." Again on page 9, respondent argues that each contract was assigned to G.M.A.C. "for the face amount thereof, but the

finance company withheld a portion from each contract which was retained in a reserve."

There are literally ten amounts to be set forth on the face of the contract (Joint Exhibit 5-E). Inference appears that petitioners, rather than G.M.A.C., received the finance charge.

What G.M.A.C. paid to petitioners was the balance of the cash sale delivered price of the car (line 3, Joint Exhibit 5-E). Petitioners then had a trade-in or a down payment or both from the purchaser, and the balance of the cash price, in cash, from G.M.A.C.

It was G.M.A.C. who owned the conditional sale contract—the right to receive the time (deferred) balance, including cost of required insurance and finance charge, from the purchaser in installments.

II.

The Finance Charge as Such Was Not Part of Petitioners' Gross Income in the Year of Sale or Ever.

In the first paragraph on page 7 of his brief, respondent maintains: "The finance charge included in the gross sale price of the automobiles sold by petitioner during the years in controvery is a part of the selling price and is properly a part of gross income in the year of sale under petitioners' accural method of accounting."

In substance the sale of an auto on credit was and had to be a single three-party transaction. The

pattern of each sale was a single transaction. Petitioners sold an auto, for trade-in and cash. G.M.A.C. sold the use of its money, for a finance charge. The purchaser bought both—the auto from the dealer, and the credit from the finance company.

The finance charge was G.M.A.C.'s price for the use of its money, and was gross income to G.M.A.C, not to petitioners.

There had to be a finance company in each transaction, because somebody had to furnish the money to buy the car from the manufacturer. G.M.A.C. was an absolutely necessary party to every sale of an auto on credit. The absence of contractual requirement to finance sales through G.M.A.C. is immaterial, where practical business necessity caused every credit sale to be so financed.

Respondent's requested finding No. 8, on page 6 of his brief, is that "Petitioner was not required to assign any of his contracts to G.M.A.C. or to any other finance company and could hold such contracts himself without assignment. (Tr. 21.)"

Let us examine the transcript, as cited by respondent:

Q. You were free to either hold these conditional sales contracts or assign them, depending on what you wanted to do?

A. What do you mean "hold them"?

Q. Hold them personally, assuming you had sufficient cash, I am not saying that you did.

A. Yes, I could have held them if I had my own contracts made up.

The Court: You could have assigned them to some other finance company too, I suppose?

The Witness: Yes, If I had the connection, which I didn't. (Tr. 20, 21; underlines added.)

Petitioners submit that the finance charge as such was gross income to G.M.A.C., and not a part of petitioners' gross income, in the year of sale or ever.

III.

By Sound Appellate Authority, the Portion of the Finance Charge Placed and Held by G.M.A.C. in Contingent Liability Reserve Was Not Gross Income to Petitioners, Unless and Until Released to Petitioners.

On this, the main issue, respondent cites Shoemaker-Nash, Inc. (1940), 41 B.T.A. 417, and four recent decisions of the Tax Court.

The Shoemaker-Nash case, supra, was distinguished by the Third Circuit in Keasbey & Mattison Co. v. United States (1944), 141 F. 2d 163, at 167 and 168:

> "The so-called 'reserve' in the Shoemaker-Nash and the Colorado Motor Car cases was really not a reserve against possible losses. There was nothing in the contract in either of those cases, so far as the Board's findings of facts disclose, to indicate that the respective

finance companies had the right to charge uncollectible notes to the 'reserve' account. * * *"

"Moreover, the amount of the 'liability' owing by the finance companies to the taxpayers in the Shoemaker-Nash and Colorado Motor Car cases was definitely determinable since the 'reserves' in those cases could not be diminished, as in the present case, by charges against them for delinquent and unpaid notes. * * *"

The Fourth Circuit, in Blaine Johnson v. Commissioner (1956), 233 F. 2d 952, at 957, commented upon the Shoemaker-Nash case as follows:

"Shoemaker-Nash is the leading case in the Tax Court, but the direction in which it leads is doubtful. * * * The Janus-like character of Shoemaker-Nash is probably due to the failure of the parties in that case to submit a full stiuplation of facts or to offer proof at the hearing, so that the court had to infer certain facts from the notice of deficiency. * * *" Blaine Johnson v. Commissioner (1956), 233 F. 2d 952, at 957.

One of the four recent decisions of the Tax Court cited by respondent, Blaine Johnson (1955) 25 T. C. 123, was reversed upon appeal, as properly admitted by respondent. The law of that case was established by appellate authority, Blaine Johnson v. Commissioner (1956), 233 F. 2d 952. Blaine Johnson did not lose; He won. What was the rule for

taxpayer Johnson, by appellate authority, should be the rule for petitioners.

In two of the four Tax Court decisions cited by respondent, Texas Trailercoach, Inc. (1956), 27 T. C. . . . No. 64, and Albert M. Brodsky (1956), 27 27 T. C. . . . No. 23, the Tax Court declined to follow Blaine Johnson v. Commissioner, supra, and held against the taxpayers. Appeal by Texas Trailercoach is pending in the Fifth Circuit.

The fourth recent Tax Court decision cited by respondent is West Pontiac, Inc. (1957), 27 T. C. . . . No. 89. Petitioners contend that the doctrine of constructive receipt, as expressed in Spring City Foundry Co. v. Commissioner (1934), 292 U. S. 182, 184, 185, 54 S. Ct. 644, 645, 78 L. Ed. 1200, was strained in the West Pontiac, Inc. decision. Petitioners contend that no right to receive liability reserve accrued to them, until and unless the conditions precedent were met, for the reasons set forth on pages 11 through 15 of petitioners' opening brief.

Petitioners appreciate and respect the status of the Tax Court of the United States as an independent agency of the Executive Branch of the Government; and appreciate the difficulty and importance of uniformity in federal tax interpretation. What petitioners plead for here, respectfully, is that the interpretation be in conformity with the appellate authority, rather than contrary to it.

* * *

V.

Penalties for Substantial Underestimation Would Be Contrary to Logic; Authority Is Divided.

Respondent cites his own regulation to the effect that where no declaration of estimated tax is filed, the amount of estimated tax is zero. This fiction was "rejected as contrary to a proper construction of the statutes," in U. S. v. Ridley (1954), 120 F. Supp. 530, 538. The Ridley decision was supported in Owen v. United States (1955) 134 F. Supp. 31.

Respondent also cites G. E. Fuller (1953), 20 T. C. 308, Fred N. Acker (1956), 26 T. C. 107, and John R. Rictor (1956), 26 T. C. 913. It is true that these three Tax Court cases do support respondent's position. Note that the Fuller case was a confiscated whiskey case, and that the Acker case was a fraud case, which suggests grounds for severity not present in the instant case.

Petitioners rely upon the authorities and reasoning set forth in their opening briefs.

Conclusion

Petitioners submit that the finance fees withheld from them by G.M.A.C. in a reserve which they could not reach, were not income to them until and unless released to them from that reserve; that there was reasonable cause for petitioners' failure to file declarations of estimated tax for the years at issue; that the penalty for substantial underestimation was not incurred by the failure to file declarations of estimated tax; and that the same

amount of $4,462.27 was erroneously allocated to income for both 1952 and 1953, in petitioners' returns and in respondent's Notice of Deficiency.

Wherefore petitioners pray that respondent's determination be held erroneous and be reversed by this Court.

/s/ EMMETT E. McINNIS JR.,
Attorney for Petitioners.

Served and entered May 20, 1957.

[Endorsed]: Filed May 20, 1957.

[Title of Tax Court and Cause.]

MEMORANDUM FINDINGS OF FACT AND OPINION

Tietjens, Judge:

The Commissioner determined the following deficiencies in income tax and additions to tax:

		Additions to Tax	
Taxable Year	Deficiency	Section 294 (d)(1)(A)	Section 294 (d)(2)
1951	$1,092.66	$ 847.66	$ 565.10
1952	686.40	563.51	375.67
1953	5,124.24	703.91	469.26

The issues for decision are (1) whether petitioner, an automobile dealer reporting on an accrual method of accounting, must include in income amounts retained in a reserve account by General Motors Acceptance Corporation, and (2) whether the Commissioner properly determined additions

to tax both under sections 294(d)(1)(A) and 294(d)(2) for failure to file declarations of estimated tax and substantial underestimation of tax.

Findings of Fact

Some of the facts are stipulated and the stipulation and pertinent exhibits are made part hereof by reference.

Petitioners are husband and wife residing at Bellevue, Washington. They timely filed joint income tax returns for the years 1951, 1952, and 1953, with the collector of internal revenue at Tacoma, Washington.

Petitioner John R. Hansen (herein called petitioner) was a Buick automobile dealer engaged in the business of selling automobiles at retail. Petitioner sold automobiles under conditional sales contracts providing for payment of the purchase price in installments, using a form of contract provided by the General Motors Acceptance Corporation (hereinafter referred to as G.M.A.C.). This contract called for a "Total Time Price" for the automobile sold. This price was computed by subtracting the down payment, including the trade-in, if any, from the "Cash Sale Delivered Price" and adding to this difference the cost of any insurance and finance charges. Thus an amount was arrived at called the "Time (Deferred) Balance." The down payment was added back to the latter amount to fix the "Total Time Price."

The form contract included the following endorsement, which was executed by petitioner upon assignment of the contract to G.M.A.C.

> For value received, undersigned does hereby sell, assign and transfer to the General Motors Acceptance Corporation his, its or their right, title and interest in and to the within contract, herewith submitted for purchase by it, and the property covered thereby and authorizes said General Motors Acceptance Corporation to do every act and thing necessary to collect and discharge the same.
>
> The undersigned certifies that said contract arose from the sale of the within described property, warranting that title to said property was at time of sale and is now vested in the undersigned free of all liens and encumbrances; that said property is as represented to the purchaser of said property by the undersigned and that statements made by the purchaser of said property on the statement form attached hereto are true to the best of the knowledge and belief of the undersigned.
>
> In consideration of your purchase of the within contract, undersigned guarantees payment of the full amount remaining unpaid hereon, and covenants if default be made in payment of any instalment herein to pay the full amount then unpaid to General Motors Acceptance Corporation upon demand, except as otherwise provided by the terms of the present General Motors Acceptance Corporation

> Retail Plan. Liability of the undersigned shall not be affected by any indulgence, compromise, settlement, extensions or variation of terms of of the within contract effected with, or by the discharge or release of the obligation of the purchaser or any other person interested, by operation of law or otherwise. Undersigned waives notice of acceptance of this guaranty and notices of non-payment and non-performance.

Petitioner financed all of his conditional sales during 1951, 1952, and 1953 through GMAC. He assigned his contracts pursuant to the terms of the endorsement contained thereon, in exchange for the amount set forth in the contract, but reduced by an amount withheld and placed in a reserve account. There was no specific contract with GMAC requiring petitioner to assign any of his contracts to GMAC. Petitioner was not required to assign any of his contracts to GMAC or to any other finance company and could hold such contracts himself without assignment.

A reserve account was maintained between petitioner and GMAC under which at least 5 per cent of the outstanding balances of the contracts assigned to GMAC were retained by it. This reserve was maintained in order to protect GMAC against any loss arising from the repossession of any automobile in case of default in payment. Also, in the event of prepayment by a customer, the proportionate

reduction in finance charges was charged to the reserve.

Petitioner's books of account and income tax returns were maintained and filed on an accrual method of accounting. Petitioner had opening and closing inventories and accounts receivable. He charged off bad debts specifically as they became worthless.

In reporting income from his automobile business and in maintaining his accounts, petitioner debited the amount placed in the reserve to an account entitled "Due Finance Company" and credited an account entitled "Reserve for Repossession." In their income tax returns for 1951 and 1953 petitioners did not include in income the amounts withheld by GMAC. These amounts were placed in the reserve account.[1]

Petitioners reported the amounts retained in the reserve account as income in the years when it was paid to them by GMAC.

Petitioners did not file a declaration of estimated tax for any of the years in controversy.

Ultimate Conclusions

The amounts retained in the reserve account and not reported by pettioners are a part of their gross

[1]The proper amount to be treated as placed in the reserve account in 1953 is in controversy here. We make no finding with respect to the proper amount to be included in income for that year as it appears that the parties will be able to agree in a Rule 50 computation on the correct figure.

income in the years when the amounts were placed in the reserve account.

The failure to file declarations of estimated tax was not due to reasonable cause. The additions to tax determined pursuant to section 294(d)(1)(A) and 294(d)(2) were properly determined by the Commissioner.

Opinion

The principles which require petitioners to include in income the amounts placed in the reserve account in the years in which such amounts were placed in the reserve account have been thoroughly explained in Albert M. Brodsky, 27 T.C. 216; Texas Trailercoach, Inc., 27 T.C. 575; and West Pontiac, Inc., 27 T.C. 749. In those cases this Court has fully and carefully reconsidered its position on this question in the light of Johnson vs. Commissioner (C.A. 4), 233 F. 2d 952, on which petitioners strongly rely, and, despite our respect for the Court of Appeals for the Fourth Circuit, we have declined to follow its decision in the Johnson case which reversed this Court's decision, 25 T.C. 123. Accordingly, on the reserve account issue, we sustain the Commissioner.

On the issue of the propriety of determining additions to tax for failure to file declarations of estimated tax, we quote petitioners' argument:

> Were the failures to file due to reasonable cause and not to wilful neglect? The evidence shows that petitioner John R. Hansen is a business man rather than an accountant or tax ex-

pert or attorney. He was responsible for important decisions for his automobile dealership. He had to promote the sale of new and used cars; to appraise used cars and to approve all trade-ins; to hire and deal with employees; to supervise the repair and service departments and the auto parts department; and to direct his advertising and public relations.

The evidence further shows that petitioner Shirley G. Hansen, during the same years, was fully occupied in caring for the home and the children of petitioners.

As a result, petitioners delegated their bookkeeping and tax problems to others, during the tax years at issue. The testimony shows that the bookkeeping was done by a girl and by a bookkeeper who came over once a week. Petitioner John R. Hansen had a brother-in-law make out his income tax all the time. Those persons and petitioners were unaware of the statutory requirement of filing declaration of estimated tax.

In a regular and consistent system of accounting and tax payment, the taxpayers filed their final returns for each of the three years in issue, and paid their tax in full as they had calculated it. The final 1040 return for each year was such as to indicate clearly to a tax expert that estimated returns should have been filed. This consistent and patent mistake was never corrected. A telephone call or a form letter from the In-

ternal Revenue office would have enabled the taxpayers to avoid further violations. For the entire three years the taxpayers believed in good faith that they were doing all that was required of them, by filing their timely annual returns and paying their taxes each year.

Petitioners first learned that they were obliged to file declarations of estimated tax, in 1954, when they secured the services of a professional tax accountant * * *. Not until 1954 did the Internal Revenue Service call to petitioners' attention their failure to file declarations of estimated tax for the three preceding years.

Petitioners submit that their consistent filing of annual returns without knowing or being notified that estimated returns should have been filed, was reasonable cause for their failure to file estimated returns.

We think these arguments are self defeating. Petitioners have failed to show that their failure to file declarations of estimated tax was "due to reasonable cause and not to wilful neglect." On this issue, we uphold the Commissioner's determination.

The last issue concerns the propriety of the Commissioner's determination of additions to tax for "substantial underestimation." Petitioners recognize that this Court has consistently approved the action of the Commissioner in determining additions to tax in the same case, both for failure to file a declara-

tion of estimated tax and for substantial underestimation. G. E. Fuller, 20 T.C. 308, affd. on another issue (C.A. 10), 213 F. 2d 102; Fred N. Acker, 26 T.C. 107; John R. Rictor, 26 T.C. 913; Harold C. Marbut, 28 T.C. .... (Filed June 24, 1957). On the authority of the cited cases we uphold the Commissioner on this isue.

Because of other adjustments a Rule 50 computation is necessary for each of the taxable years.

Decision will be entered under Rule 50.

Served June 28, 1957.

Entered June 28, 1957.

Filed June 28, 1957.

[Title of Tax Court and Cause.]

COMPUTATION FOR ENTRY OF DECISION

The attached computation reflecting deficiencies in income tax and sections 294(d)(1)(A) and 294 (d)(2) penalties for the taxable years 1951, 1952 and 1953 is submitted on behalf of the respondent in compliance with the opinion of the Court determining the issues in this proceeding. The amounts are as follows:

Taxable Year	Deficiency	Penalties	
		Section 294 (d)(1)(A)	Section 294 (d)(2)
1951	$1,092.66	$ 847.66	$ 565.10
1952	686.40	563.51	375.67
1953	3,221.46	532.64	355.10

The computation is submitted without prejudice to the respondent's right to contest the correctness of the decision entered herein by the Court pursuant to the statute in such cases made and provided.

/s/ NELSON P. ROSE, W.H.P.
Chief Counsel,
Internal Revenue Service.

Of Counsel:

MELVIN L. SEARS,
Regional Counsel;

WILFORD H. PAYNE,
Assistant Regional Counsel;

JOHN H. WELCH,
Special Attorney,
Internal Revenue Service.

Without prejudice to the right of appeal, it is agreed that the attached computation is in accordance with the opinion of the Tax Court in the above-entitled proceeding.

/s/ EMMETT E. McINNIS JR.,
Attorney for Petitioners.

Tax Court of the United States

Docket No. 62041

JOHN R. HANSEN and SHIRLEY G. HANSEN,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion filed June 28, 1957, the parties having filed on July 31, 1957, an agreed computation of tax, now, therefore, it is

Ordered and Decided: That there are deficiencies in income tax and additions to tax, as follows:

		Additions to Tax, I.R.C. of 1939	
		Section	Section
Taxable Year	Income Tax	294 (d) (1) (A)	294 (d) (2)
1951	$1,092.66	$ 847.66	$ 565.10
1952	686.40	563.51	375.67
1953	3,221.46	532.64	355.10

/s/ NORMAN O. TIETJENS,
Judge.

Served Aug. 5, 1957.

Entered Aug. 5, 1957.

Ap:S:AA:Rule 50 Recomp.
JHW:MHB

Respondent's Computation of Entry of Decision
Under Rule 50

In re: John R. Hansen and Shirley G. Hansen
3001-122nd Place N. E.
Bellevue, Washington
(Formerly: Route 4, Box 147, Kirkland, Wash.)

Docket No. 62041

Income Tax Liability for the Taxable Years Ended December 31, 1951, December 31, 1952, and December 31, 1953

The attached proposed computation is submitted, on behalf of respondent, in compliance with the Court's opinion determining the issues in this proceeding. Said computation provides that the deficiencies and penalties to be found by the Court are as follows:

Year	Kind of Tax	Deficiency	Penalties Section 294 (d)(1)(A)	Penalties Section 294 (d)(2)
1951	Income	$1,092.66	$ 847.66	$ 565.10
1952	Income	686.40	563.51	375.67
1953	Income	3,221.46	532.64	355.10
	Totals	$5,000.52	$1,943.81	$1,295.87

Taxable Year Ended December 31, 1951
Schedule 1
Computation of Tax

	Tax	Penalties Sec. 294 (d)(1)(A)	Penalties Sec. 294 (d)(2)
Liability	$9,499.36	$847.66	$565.10
Liability disclosed by return: Original Account No. BF 554	8,406.70	None	None
Statutory deficiency	$1,092.66	$847.66	$565.10
Liability	$9,499.36	$847.66	$565.10
Paid March 15, 1952	8,406.70	None	None
Deficiency in payment	$1,092.66	$847.66	$565.10

Return filed March 17, 1952.
Deficiency letter mailed January 27, 1956.
Petition filed April 26, 1956.

Taxable Year Ended December 31, 1952

Schedule 2
Computation of Tax

	Tax	Penalties Sec. 294 (d)(1)(A)	Penalties Sec. 294 (d)(2)
Liability	$6,342.14	$563.51	$375.67
Liability disclosed by return: Original Account No. AF 708799	5,655.74	None	None
Statutory deficiency	$ 686.40	$563.51	$375.67
Liability	$6,342.14	$563.51	$375.67
Paid March 15, 1953	5,655.74	None	None
Deficiency in payment	$ 686.40	$563.51	$375.67

Return filed March 16, 1953.
Deficiency letter mailed January 27, 1956.
Petition filed April 26, 1956.
Claim for refund filed March 1, 1956.

Taxable Year Ended December 31, 1953

Schedule 3
Adjustments to Net Income

Net income disclosed by deficiency letter dated January 27, 1956	$27,477.22
As adjusted	23,014.95
Adjustment	$ 4,462.27
Reduction:	
1. Finance reserve credit	$4,462.27

Schedule 3-a
Explanation of Adjustments

1. Pursuant to the opinion of the Tax Court of the United States filed on June 28, 1957, the amounts withheld by GMAC in a reserve account are includable in petitioners' gross income in the years when the amounts were placed in such account. The parties have agreed that the petitioners included $4,462.27 from this source in 1952 income and that the same amount was also included in 1953 income. Since the finance reserve credit was properly included in 1952 income, adjustment is herein made to reduce 1953 income by the duplicated amount of $4,462.27.

Schedule 4
Computation of Tax

Net income as adjusted, Sch. 3	$23,014.95
Less: Exemptions	3,000.00
Balance	$20,014.95
One-half of such balance	$10,007.48
Combined normal tax and surtax on $10,007.48	$ 2,959.14
Total combined normal tax and surtax—$2,959.14 times 2	$ 5,918.28
Self-employment tax	81.00
Income tax liability	$ 5,999.28

	Tax	Penalties Sec. 294 (d)(1)(A)	Penalties Sec. 294 (d)(2)
Liability	$5,999.28	$532.64	$355.10
Liability disclosed by return: Original Account No. OF 1039166	2,777.82	None	None
Statutory deficiency	$3,221.46	$532.64	$355.10
Liability	$5,999.28	$532.64	$355.10
Paid—March 15, 1954	2,777.82	None	None
Deficiency in payment	$3,221.46	$532.64	$355.10

Return filed March 15, 1954.
Deficiency letter mailed January 27, 1956.
Petition filed April 26, 1956.

[Endorsed]: Filed July 31, 1957.

In the United States Court of Appeals
for the Ninth Circuit
T.C. Docket No. 62041

JOHN R. HANSEN and SHIRLEY G. HANSEN,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REVIEW

Now come John R. Hansen and Shirley G. Hansen, by their attorney, Emmett E. McInnis, Jr., and petition the United States Court of Appeals for the Ninth Circuit to review the decision of the Tax Court of the United States rendered on August 1, 1957, TC Memo 1957-113, No. 62041, determining deficiencies and penalties in the petitioner's Federal income taxes for the calendar years 1951, 1952, and 1953, in the respective amounts of $2,505.42, $1,625.58, and $4,109.20. Jurisdiction is by Section 7482(a) of the Internal Revenue Code.

Venue for review by the United States Court of Appeals for the Ninth Circuit, is based upon Section 7482(b)(1) of the Internal Revenue Code. The returns of tax in respect to which the controversy arises, were made to the office of the Internal Revenue Service in Tacoma, Washington, within the Ninth Circuit.

/s/ EMMETT E. McINNIS, JR.,
Counsel for Petitioners.

[Endorsed]: Filed Nov. 4, 1957.

[Title of Court of Appeals and Cause]

NOTICE OF FILING PETITION FOR REVIEW

To: Nelson P. Rose, Chief Counsel, Internal Revenue Service, Washington, D.C.

You are hereby notified that the petitioners on the 31st day of October, 1957, filed by mail with the Clerk of the Tax Court of the United States at Washington, D. C., a petition for review by the United States Court of Appeals for the Ninth Circuit of the decision of the Tax Court of the United States heretofore rendered in the above-entitled cause. A copy of the petition for review and a copy of the statement of points to be urged, as filed, are hereto attached and served upon you.

Dated at Seattle, Washington, this 31st day of October, 1957.

Respectfully,

/s/ EMMETT E. McINNIS, JR.,
Counsel for Petitioners.

Service acknowledged.

[Endorsed]: Filed Nov. 4, 1957.

In the United States Court of Appeals
for the Ninth Circuit

No. 15821

JOHN R. HANSEN and SHIRLEY G. HANSEN,

Petitioners on Review,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent on Review.

STATEMENT OF POINTS

Now come John R. Hansen and Shirley G. Hansen, the petitioners herein, by their attorney, Emmett E. McInnis, Jr., and hereby assert the following errors, which they intend to urge on review, by the United States Court of Appeals for the Ninth Circuit, of the decision of the Tax Court of the United States rendered in the above cause on August 1, 1957:

1. The Tax Court erred in holding that finance fees withheld in contingent liability reserve by General Motors Acceptance Corporation, accrue as income to petitioner John R. Hansen, an automobile dealer, in the year in which the reserves were created by G.M.A.C., rather than when and if released to petitioner.

2. The Tax Court erred in sustaining penalties imposed for substantial underestimation of declaration of estimated tax, under I.R.C. (1939) sec. 294

(d)(2), where no estimated returns at all were filed and where the explicit penalties for failures to file were imposed under I.R.C. (1939) sec. 294 (d)(1)(A).

The Tax Court erred in sustaining penalties where the penalties were based upon amounts erroneously held to be income, as first hereinabove stated; both as to penalties imposed for failure to file declarations of estimated tax, under I.R.C. (1939) sec. 294 (d)(1)(A), and as to penalties imposed for substantial underestimation, under I.R.C. (1939) sec. 294 (d)(2).

4. The foregoing errors render erroneous the entry of decision wherein the Tax Court ordered and decided that there are deficiencies for the taxable years of 1951, 1952 and 1953, totalling $8,240.20.

/s/ EMMETT E. McINNIS, JR.,
Counsel for Petitioners.

Statement of service attached.

[Endorsed]: Filed Dec. 18, 1957.

[Title of Tax Court and Cause.]

DESIGNATION OF CONTENTS OF RECORD ON REVIEW

To the Clerk of the Tax Court of the United States:

You will please prepare, transmit, and deliver to the Clerk of the United States Court of Appeals for

the Ninth Circuit, copies duly certified as correct of the following documents and records in the above-entitled cause, in connection with the petition for review heretofore filed by John R. Hansen and Shirley G. Hansen:

(1) The docket entries of all proceedings before the Tax Court.

(2) Pleadings before the Tax Court, as follows:

(a) Stipulation of Facts.

(b) Amended Petition.

(c) Answer to Amended Petition.

(d) Brief for Petitioners, omitting the following:

(aa) From Finding of Fact No. 20, at foot of page 7, through Finding of Fact No. 29 on page 9.

(bb) Part III of Argument, from page 15 through middle of page 18.

(cc) Part IV of Argument, from page 21.

(e) Reply Brief for Petitioners, omitting all of part IV, on pages 10 and 11.

(3) Memorandum Findings of Fact and Opinion, of the Tax Court.

(4) Computation for Entry of Decision.

(5) Decision of the Tax Court.

(6) Petition for Review.

(7) Notice of Filing Petition for Review.

(8) Statement of Points.

(9) From the evidence, Joint Exhibit 5-E, Conditional Sale Contract.

(10) From the official transcript of oral testimony:

(a) The testimony of John R. Hansen: from "The Clerk: Will you * * *" on page 11, through "* * * and keep the difference." on page 14; from "Q. (By Mr. McInnis) Were losses * * *" at the foot of page 14 through "* * * did you declare them as income? A. Yes," at the middle of page 16; and from "Q. Do you at the present time * * *" on page 20 through "* * * which I didn't." on page 21.

(b) The testimony of Dallas L. Carter: from "The Clerk: Will you * * *" on page 22 through "* * * from the finance company," on page 24; from "A. Mr. Hansen's books * * *" on page 26 through "* * * the requirements of good accounting," on page 26; from "Q. (By Mr. McInnis) To your knowledge * * *" on page 29 through "* * * with the financing of automobiles," on page 30; and from "Q. In your opinion * * *" on page 31 through "* * * that he should have of that reserve," on page 31.

(11) This designation of Contents of Record on Review.

/s/ EMMETT E. McINNIS, JR.,
Counsel for Petitioners.

Service acknowledged.

[Endorsed]: Filed Nov. 4, 1957.

[Title of Tax Court and Cause.]

CERTIFICATE

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the foregoing documents, 1 to 24, inclusive, constitute and are all of the original papers on file in my office as called for by the "Designation of Contents of Record on Review" and "Designation of Additional Portions of Record," including exhibits 1-A thru 5-E attached to the Stipulation of Facts, in the case before the Tax Court of the United States docketed at the above number and in which the petitioners in the Tax Court have filed a petition for review as above numbered and entitled, together with a true copy of the docket entries in said Tax Court case as the same appear in the official docket book in my office.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 20th day of November, 1957.

[Seal] /s/ HOWARD P. LOCKE,
Clerk, Tax Court of the
United States.

Supreme Court of the United States

No. 380, October Term, 1958

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN R. HANSEN and SHIRLEY G. HANSEN

Order allowing certiorari

November 10, 1958

The petition herein for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit is granted. The case is consolidated with No. 381 and a total of two hours is allowed for oral argument.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ. [98]

[Endorsed]: No. 15821. United States Court of Appeals for the Ninth Circuit. John R. Hansen and Shirley G. Hansen, Petitioners, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Petition to Review a Decision of The Tax Court of the United States.

Filed: December 6, 1957.

Docketed: December 18, 1957.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for the Ninth Circuit.

[Title of Court of Appeals and Cause.]

STATEMENT OF POINTS

Now come John R. Hansen and Shirley G. Hansen, the petitioners herein, by their attorney, Emmett E. McInnis, Jr., and hereby assert the following errors, which they intend to urge on review, by the United States Court of Appeals for the Ninth Circuit, of the decision of the Tax Court of the United States rendered in the above cause on August 1, 1957:

1. The Tax Court erred in holding that finance fees withheld in contingent liability reserve by General Motors Acceptance Corporation, accrue as income to petitioner John R. Hansen, an automobile dealer, in the year in which the reserves were created by G.M.A.C., rather than when and if released to petitioner.

2. The Tax Court erred in sustaining penalties imposed for substantial underestimation of declaration of estimated tax, under I.R.C. (1939) sec. 294 (d)(2), where no estimated returns at all were filed and where the explicit penalties for failures to file were imposed under I.R.C. (1939) sec. 294 (d)(1)(A).

3. The Tax Court erred in sustaining penalties where the penalties were based upon amounts erroneously held to be income, as first hereinabove stated; both as to penalties imposed for failure to file declarations of estimated tax, under I.R.C. (1939) sec. 294 (d)(1)(A), and as to penalties im-

posed for substantial underestimation, under I.R.C. (1939) sec. 294 (d)(2).

4. The foregoing errors render erroneous the entry of decsion wherein the Tax Court ordered and decided that there are deficiencies for the taxable years of 1951, 1952 and 1953, totalling $8,240.20.

/s/ EMMETT E. McINNIS, JR.,
Counsel for Petitioners.

[Endorsed]: Filed Nov. 4, 1957.

[83a] In United States Court of Appeals for the Ninth Circuit

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[84] United States Court of Appeals for the Ninth Circuit

Minute entry of argument and submission—May 13, 1958 [omitted in printing].

In United States Court of Appeals for the Ninth Circuit

Before POPE, BARNES and HAMLEY, Circuit Judges

Minute entry of order directing filing of opinion and filing and recording of judgment

August 4, 1958

Ordered that the typewritten opinion this day rendered in above cause be forthwith filed by the Clerk, and that a Judgment be filed and recorded in the minutes of the Court in accordance with the opinion rendered. [85]

In United States Court of Appeals for the Ninth Circuit

No. 15,821

JOHN R. HANSEN and SHIRLEY G. HANSEN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

Opinion

August 4, 1958

Before POPE, BARNES and HAMLEY, Circuit Judges

BARNES, Circuit Judge: Taxpayers, husband and wife, have petitioned for review of a memorandum decision of the Tax Court sustaining deficiencies in income taxes for the years 1951, 1952, and 1953 and imposing penalties for failure to file estimated returns and for substantial underestimation of taxes for those years.

John R. Hansen (hereinafter referred to as petitioner) was, in the years in question, engaged in the business of selling new automobiles. It is stipulated that all such sales were financed by the General Motors Acceptance Corporation (GMAC). As a part of the normal course of dealing, and apparently pursuant to a GMAC "Retail Plan" referred to at the trial, GMAC paid Hansen 95% of the sales price of the car at the time of the sale and retained in a dealer reserve account the remaining 5%. GMAC also credited to that account a certain percentage of the financing charges as payments from the purchaser were received. Under this arrangement no portion of the 5% reserve account was payable to Hansen except at the complete discretion of GMAC; [86] and release of any funds was contingent on their being in the reserve account an amount in excess of 5% of all outstanding contracts. Petitioner, an accrual basis taxpayer, returned as income in the year of sale 95% of the sales price of each automobile sold. He did not accrue and return as income the GMAC reserves in the year of sale—the year they were established. His books reflected an asset account "Due Finance Co." and a liability

account "Reserve for Repossession," but these were never taken into or deducted from income. Taxpayer used a specific charge-off account for bad debts arising from the business, but no losses on GMAC reserves were charged to this account. This bad debt account was unrelated to the credit sales financed through GMAC. Petitioner reported as income the amounts paid from these accounts in the year they were released to him by GMAC.

The Commissioner determined that the finance charge attaching to each sale was an integral part of the selling price; that the right to receive from the purchaser the full amount of the contract price was fixed in the year of sale; and that the dealer's reserve was contingent for possible losses and not a proper basis for reduction of gross income. The Tax Court sustained this determination, holding that the amount credited to the dealer's reserve was accruable into income in the year credited to the reserve account. The Tax Court also sustained the penalties for failure to file an estimated return and for substantial underestimation of taxes. From these two holdings, this petition for review was prosecuted.

I. ACCRUABILITY OF DEALER RESERVES

The problem before us is not new to the tax law, although it is apparently one of first impression in this Court. The Tax Court has consistently held dealer reserve accounts accruable in the year established, not in the year of actual payment to the dealer.[1] With equal consistency the Courts of Appeals and the District [87] Courts have taken the opposite view.[2] The source of taxpayer's anguish in these cases is that

[1] Evans Motor Co., 1957, 29 T. C. No. 62; Kilborn, 1957, 29 T. C. No. 14; Morgan, 1957, 29 T. C. No. 9; West Pontiac, 1957, 27 T. C. 749; Texas Trailercoach, 1956, 27 T. C. 575; Brodsky, 1956, 27 T. C. 216; Blaine Johnson, 1955, 25 T. C. 123; Shoemaker-Nash, 1940, 41 B. T. A. 417.

[2] Glover v. Comm'r, 8 Cir., 1958, 253 F. 2d 735; West Pontiac v. Comm'r, 5 Cir., 1958, — F. 2d —; Texas Trailercoach v. Comm'r, 5 Cir., 1958, 251 F. 2d 395, reversing 27 T. C. 575; Johnson v. Comm'r, 4 Cir., 1956, 233 F. 2d Modern Olds v. United States, N. D. Tex., 1957, — F. Supp. —; Hines Pontiac v. United States, N. D. Tex., 1957, — F. Supp. —; Massey Motors v. United States, S. D. Fla., 1957, 156 F. Supp. 516; Marine Chevrolet Co., Inc. v. United States, 1958, — F. Supp. —; C. C. H. Fed. Tax. 1958, para. 9441. The issue is pending in this Circuit in Morgan v. Comm'r, #15898; in the sixth circuit in Schaeffer v. Comm'r, #13421; cf. Keasby & Mattison v. United States, 3 Cir., 1944, 141 F. 2d 163. But cf. Baird v. C. I. R., 7 Cir., decided June 20, 1958, — F. 2d —.

a tax must be paid without the funds upon which the tax is levied being available for payment of the tax. This may often be the result of accrual accounting just as it may be the result of operation of the doctrines of realization and constructive receipt. We are not impressed with the emphasis placed on this element of the case by those courts which have resolved the problem in favor of the taxpayer. On the other hand, the government is not being deprived of revenue in the long run. There is here no tax avoidance device. The dealer reserve amounts have always been reported as income in the year received. The only difference between the taxpayer and his government, therefore, is *when*, not whether, the amounts are taxable as income.

Certain principles are appropriate for review. A cash basis taxpayer records income upon actual or constructive receipt—and it is well to note that constructive receipt means that the taxpayer *has the present right to receive* funds which he, for his own reasons, chooses not to exercise (Treas. Reg. 118, § 39.42–2). An accrual basis taxpayer must record income, and pay tax thereon, upon *fixation* of the right to receive income, not upon its actual or constructive receipt.

"When the right to receive an amount becomes fixed, the right accrues."[3]

With these basic concepts well in mind, we move to a consideration of the transactions here involved. [88]

Hansen, as an automobile dealer, financed all sales exclusively through GMAC and all sales were written up on a form conditional sales contract supplied by GMAC. This contract provided for a "Total Time Price" computed, in a vastly simplified version, by adding to the cash price of the car (cost plus profit) the finance charges required by GMAC. This total time price reduced by the purchaser's down payment results in the "Time (Deferred) Balance" which becomes due and payable at the GMAC office in whatever number of installments are determined. This contract also provides, beneath the signatures of seller and purchaser, a "Dealer's Recommendation, Assignment and Guaranty," which provides, "for value received," for an immediate assignment to GMAC of the dealer's interest in the contract.

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[3] Spring City Co. v. Comm'r, 1934, 292 U. S. 182, 184.

The transaction consummated and evidenced by this contract is subject to three possible interpretations. The government urges that there are here two separate sales: first, of the car by the dealer to the purchaser, giving rise to fixation of the right to receive the "Total Time Price" and requiring that amount to be accrued in the year of sale; second, of the conditional sales contract by the dealer to GMAC, for which GMAC pays less than the fair market value, but which can serve only as a basis for potential loss deductions not here pertinent.[4] We are in complete agreement with the Court in Texas Trailercoach v. Comm'r, 5 Cir. 1958, 251 F. 2d 395, that such a view is totally unrealistic. Such an artificial characterization of the transaction ignores entirely the complete integration of the financing institution that has become the hallmark of the automobile industry. It also ignores the uncontradicted evidence in the instant case showing that all sales were in fact so financed and that no sales could have been consummated without the financial assistance of GMAC.

The transaction, we believe, is properly construed as a single three-cornered arrangement involving the dealer, the purchaser, and the finance company.[5] But even so, this does not solve [89] the problem. The transaction may still be seen as singular, while its elements are plural. It can be reasoned that the right to the sale price is fixed at the time of the contract, thereby requiring the dealer to accrue that amount, although he has actual receipt of only 95% thereof (cf. Commissioner v. Cleveland Tr. Paving Co., 6 Cir., 1932, 62 F. 2d 85.) The only amount not includable in the year of sale would then be that portion of the finance charges to which the dealer is entitled as they become fixed. (See the opinion of Black, J., in Texas Trailercoach, 1956, 27 T. C. 575, 580.) Although such an approach is entirely consistent with the principles of accrual accounting noted earlier, we are of the opinion that the peculiarities of automobile financing make this interpretation as unrealistic as that already rejected. We think Judge Wisdom ably and adequately stated the realities of this type

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[4] To infer, as does the government, that the only question here is one of deductions "seems to shut off the inquiry at the point where we would begin and raises a question * * * that is not present in the case before us." Texas Trailercoach v. Comm'r, supra, p. 397.

[5] Glover v. Comm'r, supra, note 2; Texas Trailercoach v. Comm'r, supra, note 2; Johnson v. Comm'r, supra, note 2.

of transaction in the Texas Trailercoach case, supra, where at p. 397, after expressing the general belief that "Tax incidence should reflect the realities of a business transaction," he stated:

"When we get down to what actually happens * * * we find one transaction, a three-cornered agreement with interrelated obligations of dealer, purchaser and finance company. Instead of being out of the first step of the transaction (the trailer sale to the purchaser), the finance company dictates the terms of the sale, has obligations running to it in the sales contract, has a fixed percentage for its finance charges worked into the sales price, and is as much a part of the substance of the business transaction as the dealer—whether or not it is the dealer who transfers the title formally to the purchaser, apparently for one hundred per cent of the purchase price. The hard core of the factual situation is that, under the three-way agreement, the dealer receives from the purchaser only a ninety-five per cent claim of right to the unpaid balance, plus a contingent claim, against the purchaser, to the remaining five per cent subject to a number of important conditions in favor of the finance company. The dealer transfers to the finance company, simultaneously, only what he receives from the purchaser. He receives from the finance company ninety-five per cent of the sales price plus a contingent claim, against the finance company, to the remaining five percent then entirely under the dominion and control of the finance company. The dealer's claim to this [90] five per cent may never become fixed or ascertainable; it may never be received."

At the time of the sale the only right which becomes fixed is the right to receive 95% of the sale price, and not the total time price, from the purchaser through GMAC. The amount credited to the dealer's reserve is completely controlled by GMAC. It is true an amount is fixed, but this amount is subject to unilateral depletion by GMAC to off-set repossession losses, prepayment refunds, and other charges determined by GMAC; the possibility of payment under this circumstance, although the maximum amount is determined, is so remote and contingent that it cannot be said to have become fixed and ascertained (cf. Long Poultry Farms v. Comm'r, 4 Cir., 1957, 249 F. 2d 726, acquiesced in by the Commissioner, Rev. Rul. 57–358, 1958 P–H para. 54–503).

We have no quarrel with the theory of the Tax Court's position. Had the petitioner financed these sales himself, or elected to sell the contract as a separate transaction, the result reached below would be correct. The dealer's recourse in those situations necessarily would be limited to the reserve for loss deductions allowed under 26 U. S. C. § 166 (formerly 26 U. S. C. § 23 (k) (1)), or the installment sale provisions of 26 U. S. C. § 453 (a) (formerly 26 U. S. C. § 44 (a)). But that is not the factual case here presented. Petitioner had no such choices available to him. He was limited to a contract whereby he would finance through GMAC and receive only 95% of the sale price, or he had no contract at all. This being so, the portion actually paid to GMAC but earmarked for petitioner was not an amount to which his right of receipt became fixed. It became fixed only when GMAC decided it should pay out some of the funds held in the dealer's reserve.

Section 41 of the Internal Revenue Code of 1939 (now 26 U. S. C. § 446) requires net income to be determined in accordance with the taxpayer's method of accounting or by the Commissioner in accordance with such methods as clearly reflect the income for the accounting period. A realistic view of the transactions of this petitioner confirms our conclusion that the Tax Court's re-allocation of income in accordance with the commissioner's assessment must be reversed in order to clearly reflect taxable income for the years in question. [91]

II. PENALTIES

Petitioner admits that he filed no estimated returns during these years and the court below found that his failure was not due to reasonable cause. This finding is not disputed. The applicable provisions of the Internal Revenue Code of 1939 are § 294 (d) (1) (A),* which provides a maximum 10% penalty for failure to file a declaration of estimated tax; and

* "§ 294 (d) Estimated tax

"(1) Failure to file declaration or pay installment of estimated tax

"(a) Failure to file declarations. In the case of a failure to make and file a declaration of estimated tax within the time prescribed, unless such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause and not to willful neglect, there shall be added to the tax 5 per centum of each installment due but unpaid, and in addition, with respect to each such installment due but unpaid, 1 per centum of the unpaid amount thereof for each month (except the first) or fraction

§ 294 (d) (2),[7] [92] which provides a maximum 6% penalty for substantial underestimation of tax.[8]

Taxpayer argues that a logical interpretation of these sections precludes assessment of both penalties where there has been a failure to file the estimated return. His argument is that there can be no underestimate where there has been no estimate at all; and since every failure to file necessarily would be a substantial underestimation, the greater must include the lesser. This position has support in a number of cases following the decision in United States v. Ridley, N. D. Ga., 1954,

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thereof during which such amount remains unpaid. In no event shall the aggregate addition to the tax under this subparagraph with respect to any installment due but unpaid, exceed 10 per centum of the unpaid portion of such installment. For the purposes of this subparagraph the amount and due date of each installment shall be the same as if a declaration had been filed within the time prescribed showing an estimated tax equal to the correct tax reduced by the credits under sections 32 and 35."

[7] "§ 294 (d) (2) Substantial underestimate of estimated tax. If 80 per centum of the tax (determined without regard to the credits under sections 32 and 35), in the case of individuals other than farmers exercising an election under section 60 (a), or 66⅔ per centum of such tax so determined in the case of such farmers, exceeds the estimated tax (increased by such credits), there shall be added to the tax an amount equal to such excess or equal to 6 per centum of the amount by which such tax so determined exceeds the estimated tax so increased, whichever is the lesser. This paragraph shall not apply to the taxable year in which falls the death of the taxpayer, nor, under regulations prescribed by the Commissioner with the approval of the Secretary, shall it apply to the taxable year in which the taxpayer makes a timely payment of estimated tax within or before each quarter (excluding, in case the taxable year begins in 1943, any quarter beginning prior to July 1, 1943) of such year (or in the case of farmers exercising an election under section 60 (a), within the last quarter) in an amount at least as great as though computed (under such regulations) on the basis of the taxpayer's status with respect to the personal exemption and credit for dependents on the date of the filing of the declaration for such taxable year (or in the case of any such farmer, or in case the fifteenth day of the third month of the taxable year occurs after July 1, on July 1 of the taxable year) but otherwise on the basis of the facts shown on his return for the preceding taxable year. 53 Stat. 88, as amended June 9, 1943, 7 p. m., E. W. T., c. 120, § 5 (b), 57 Stat. 144; Feb. 25, 1944, 12:49 p. m., E. W. T., c. 63, Title I, § 118 (a), 58 Stat. 37; May 29, 1944, 7 p. m., E. W. T., c. 210, Part I, §§ 6 (b), (8), 13 (b), 58 Stat. 235, 244."

[8] A third penalty, for failure to pay the estimated tax, was provided by § 294 (d) (1) (B), but was specifically applicable only where a declaration had been filed. These three penalty provisions have now been consolidated into one 6% penalty for underpayment of estimated tax. Int. Rev. Code of 1954, § 6654.

120 F. Supp. 530.[9] The Courts of Appeals for the Fifth Circuit (Patchen v. C. I. R., — F. 2d — (July 23, 1958)), and the Third Circuit (Abbott v. C. I. R., — F. 2d — (July 31, 1958)), and the Tax Court, however, have taken the position that these provisions are independently applicable (see e. g., Fuller, 1953, 20 T. C. 308, aff'd on other grounds, 10 Cir., 1954, 213 F. 2d 102), and other District Courts have similarly decided; Palmisano v. United States, E. D. La., 1958, 159 F. Supp. 98; Farrow v. United States, S. D. Cal., 1957, 150 F. Supp. 581; Erwin v. Granquist, D. Ore., 1957, aff'd [93] on other grounds, 9 Cir., 1958, 253 F. 2d 26, cert. denied, May 19, 1958.[10]

Were we compelled to base our decision on logic alone, we are by no means convinced that it is not as logical to read the two code sections as imposing cumulative penalties as one. However, Congress has on two occasions expressed its intention that both these penalty provisions are applicable to a taxpayer who has failed to file a declaration of estimated tax. The Senate and conference reports on the original bill containing these provisions (57 Stat. 126) contain the following language:

"In the event of a failure to file a declaration where one is due, the amount of the estimated tax for the purposes of this provision (§ 294 (d) (2)) *will be zero.*" [11]

Thus it is abundantly clear that Congress was aware of the difficulty in measuring the underestimation penalty where no estimate was filed and pursuant to this understanding indicated that in the event of a failure to file, the amount of the estimated tax would be presumed to be zero. No other conclusion is possible but that Congress intended § 294 (d) (2) penalties even in a situation giving rise to § 294 (d) (1) (A) penalties,

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[9] Accord, Acker v. C. I. R., 6 Cir., 1958, — F. 2d —; Barnwell v. United States, E. D. S. C., 1958, — F. Supp. —; Jones v. Wood, D. Ariz., 1957, 151 F. Supp. 678; Stenzel v. United States, N. D. Cal., 1957, 150 F. Supp. 634; Powell v. Granquist, D. Ore., 1956, 146 F. Supp. 308, aff'd on other grounds, 9 Cir., 1958, 252 F. 2d 56; Owen v. United States, D. Neb., 1955, 134 F. Supp. 31; Witt v. Tomlinson, S. D. Fla., 1958, — F. Supp. —; P-H Current Decisions 58-1350; Glass v. Dunn, P-H Fed. Tax. 1956, para. 73,100.

[10] Accord, Abbott, 1957, 28 T. C. 798, aff'd, 3 Cir., 1958, — F. 2d —; Beacham, 1957, 28 T. C. 598, aff'd, Beacham v. C. I. R., 5 Cir., 1958, 255 F. 2d 103; Kaltreider, 1957, 28 T. C. 121; Patchen, 1956, 27 T. C. 592, aff'd, Patchen v. C. I. R. 5 Cir., — F. 2d — (July 23, 1958); Acker, 1956, 26 T. C. 107, rev'd, Acker v. C. I. R., 6 Cir., — F. 2d — (June 18, 1958). Cf. Prokop v. C. I. R., 7 Cir., 1958, 254 F. 2d 544.

[11] S. Rep. No. 22, 1943 Cum. Bull. 1314, 1345; Conf. Rep. No. 510, 1943 Cum. Bull. 1351, 1372. (Emphasis added.)

that is, a failure to file is also a substantial underestimation of taxes due. Subsequent amendments to these provisions changed the amounts of the penalties, but in no way altered their substantive effect.

In the 1954 revision of the Internal Revenue Code, Congress recognized the double-barreled operation of these statutes in stating:

"This charge (for underestimation) and the charge for failure to file a declaration or pay an installment of estimated tax may run concurrently and result in a combined charge of 15 (sic) percent of the estimated tax due." [12] [94]

And the more lenient provisions of the present 26 U. S. C. § 6654 resulted. Thus at the time Congress changed the law, it recognized what the law then was.

We conclude from these expressions of congressional intent that where a taxpayer fails to file a declaration of estimated tax he was formerly, and during the years here involved, liable for the penalties imposed by § 294 (d) (2) as well as for those imposed by § 294 (d) (1) (A). In this respect the decision of the Tax Court is affirmed.

The judgment is affirmed as to the penalties assessed, but as to the imposition of tax on the dealer reserves the judgment is reversed and remanded for recomputation and entry of judgment in accordance with this opinion.

[File endorsement omitted.] [95]

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[12] H. Rep. No. 1337, 3 U. S. C. Cong. & Adm. News 4017, 4127 (1954).

In United States Court of Appeals for the Ninth Circuit

No. 15821

JOHN R. HANSEN and SHIRLEY G. HANSEN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Judgment

Entered August 4, 1958

PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

This cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, and was duly submitted.

On consideration whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this cause be, and hereby is affirmed as to the penalties assessed, but as to the imposition of tax on the dealer reserves the decision is reversed, and that this cause be, and hereby is remanded to the said Tax Court for recomputation and entry of judgment in accordance with the opinion of this Court.

[File endorsement omitted.] [96]

[Clerk's certificate to foregoing transcript omitted in printing.] [97]

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SUPREME COURT, U. S.

TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1958

No. 381

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER,

vs.

BURL P. GLOVER

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE EIGHTH CIRCUIT

PETITION FOR CERTIORARI FILED SEPTEMBER 18, 1958
CERTIORARI GRANTED NOVEMBER 10, 1958

Supreme Court of the United States

OCTOBER TERM, 1958

No. 381

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER,

vs.

BURL P. GLOVER

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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IN THE TAX COURT OF THE UNITED STATES

Burl P. Glover, Petitioner,
Docket No. 55083. vs.
Commissioner of Internal Revenue, Respondent.

Docket Entries.

Appearances:

For petitioner: E. Chas. Eichenbaum, Esq., Leonard L. Scott, Esq., W. S. Miller, Jr., Esq.

For respondent: Robert B. Wallace, Esq.

1954

Oct. 20—Petition received and filed. Taxpayer notified. Fee paid.
Oct. 20—Copy of petition served on General Counsel.
Nov. 26—Answer filed by General Counsel.
Nov. 26—Request for hearing in Little Rock, Arkansas filed by General Counsel.
Dec. 3—Notice issued placing proceeding on Little Rock calendar. Service of answer and request made.

1956

Aug. 16—Hearing set Dec. 3, 1956, Little Rock, Arkansas.
Dec. 5—Trial had before Judge Bruce on the merits. Submitted. Stipulation as to facts, filed at hearing. Briefs 2/21/57. Replies 3/25/57.
Dec. 26—Transcript of hearing 12/5/56 filed.

1957

Feb. 18—Brief for petitioner filed. 2/25/57 served.
[fol. 2] Feb. 21—Brief filed by respondent. 2/25/57 served.
Mar. 18—Memorandum findings of fact and opinion filed, Bruce, J. Decision will be entered under Rule 50. 3/19/57 served.
Jun. 3—Agreed computation filed.
Jun. 5—Decision entered, Judge Bruce, Division 6. 6/7/57 served.

1957

Aug. 26—Order amending decision filed. 8/28/57 served.
Aug. 27—Petition for review by United States Court of Appeals, Eighth Circuit, filed by petitioner.
Aug. 27—Designation of contents of record on appeal filed.
Aug. 27—Certification of service of petition for review and designation of contents of record on appeal on respondent filed by petitioner.

In The Tax Court of The United States.

(Title Omitted)

PETITION—filed October 20, 1954

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his Notice of Deficiency dated August 6, 1954, and as a basis of his proceeding alleges as follows:

1. The petitioner is an individual, with his residence in Pine Bluff, Arkansas. The returns for the periods here [fol. 3] involved were filed with the Collector of Internal Revenue for the District of Arkansas.

2. The Notice of Deficiency, a copy of which is attached hereto and marked Exhibit "A", was mailed to the petitioner on August 6, 1954.

3. The Commissioner determined deficiencies in income tax and penalty as follows:

Year	Deficiency	Penalty Sec. 294(d)(2)
1949	$1,749.10	0.00
1950	5,041.33	0.00
1951	2,211.88	$331.34

The entire amounts of said tax and penalty, with the exception of the tax attributable to an erroneous deduction of $506.65 in 1950, are in controversy.

4. The determination of tax set forth in said Notice of Deficiency is based upon the following errors:

(a) For 1949, the Commissioner erroneously determined that income from finance reserve should be increased by $3,885.71.

(b) For 1949, the Commissioner erroneously determined that the deduction claimed by petitioner for demonstrator expense should be decreased by $840.00, to eliminate the portion allegedly applicable to personal use.

(c) In 1949, the Commissioner erroneously determined that a Higgins boat, two Lincoln and three Mercury automobiles, were not depreciable property of petitioner, that the Higgins boat and a Lincoln Cosmopolitan Convertible automobile were not used for business purposes and that said demonstrator automobiles were held for sale to customers in the ordinary course of business. The Commissioner erroneously disallowed depreciation on these items in the amount of $2,015.81.

(d) For 1950, the Commissioner erroneously determined that income from finance reserve should be increased by $7,601.07.

[fol. 4] (e) For 1950, the Commissioner erroneously determined that the deduction claimed by petitioner for demonstrator expense should be decreased by $840.00, to eliminate the portion allegedly applicable to personal use.

(f) In 1950, Commissioner erroneously determined that the Higgins boat, Lincoln Convertible automobile and 10 automobiles used as demonstrators did not constitute depreciable property, and that depreciation in the amount of $2,159.97, attributable to said items, should be disallowed.

(g) For 1951, the Commissioner erroneously determined that income from finance reserve should be increased by $351.34.

(h) For 1951, the Commissioner erroneously determined that the deduction claimed by petitioner for demonstrator expense should be decreased by $840.00.

(i) For 1951, the Commissioner erroneously determined, for the same reason as heretofore stated, that depreciation claimed on service cars and demonstrators to the extent of $3,124.51 should be disallowed.

(j) For 1951, the Commissioner erroneously determined that the gain or loss on the sale of said Lincoln Convertible automobile should not be recognized on the ground that said automobile was used for personal purposes only. Commissioner erroneously determined that profit realized on the sale of automobiles used as demonstrators is taxable as ordinary income, and erroneously increased income in the amount of $178.22 as a result of said adjustments.

(k) For 1951, Commissioner erroneously applied a penalty of $331.34, under sec. 294(d)(2), Internal Revenue Code of 1939.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) During all of the years involved, petitioner operated an automobile sales business in Arkansas. During [fol. 5] all of the years involved, petitioner operated under a finance contract with Universal CIT Credit corporation, under which contract a finance reserve account was maintained by Universal in petitioner's name. A balance equal to 3% of the outstanding notes financed at petitioner's request was required to be maintained under restrictions placing said balance completely beyond the control and right to receipt or disposition by petitioner. Petitioner received payment periodically of the reserve balance in excess of said 3%. During 1949, petitioner reported all credits to said reserve account except an amount of $3,885.71. The amount of $3,885.71 constituted the minimum 3% reserve required under said contract, and petitioner at no time had the right to the use, control, or disposition of said sum. Said amount does not constitute taxable income to petitioner during the year 1949.

(b) During the year 1949, petitioner used certain cars as service cars and demonstrator cars, and claimed as a deduction the amount of $1,823.02 as demonstrator expense. Said expenses were incurred as ordinary and necessary business expenses in the operation of petitioner's business, and are properly allowable in full as deductions for income tax purposes.

(c) In 1949, petitioner used a Higgins boat, and a Lincoln Cosmopolitan Convertible automobile, two Lincoln

and three Mercury automobiles as service cars, and claimed a deduction for depreciation on said items in the total amount of $2,973.65. The Higgins boat was used in all years for the purpose of entertaining prospective customers, providing recreation for company employees and promoting good will. The said vehicles were all used for business purposes throughout said year. The depreciation deduction claimed with respect to the above items constitutes an ordinary and necessary business expense, and is properly allowable in full.

(d) During the year 1950, petitioner reported all credits to the reserve account described in sub-paragraph 5(a), with the exception of the amount of $7,601.07. During [fol. 6] said year, said amount of $7,601.07 constituted the minimum reserve required under said contract, and petitioner at no time had the right to the use, control, or disposition of said sum. Said amount does not constitute taxable income to petitioner during the year 1950.

(e) During the year 1950, petitioner used certain cars as service cars and demonstrator cars, and claimed as a deduction the amount of $5,721.19 as demonstrator expense. Said expenses were incurred as ordinary and necessary business expenses in the operation of petitioner's business, and are properly allowable in full as deductions for income tax purposes.

(f) In 1950, petitioner used a Higgins boat, and Lincoln Convertible automobile and 10 other automobiles as demonstrators or service cars, and claimed a deduction for depreciation on all of said items in the amount of $2,569.23. The Higgins boat and all of said vehicles were used for business purposes throughout said year. The depreciation deduction claimed with respect to the above items constitutes an ordinary and necessary business expense and is properly allowable in full.

(g) During the year 1951, petitioner reported all credits to the reserve account described in sub-paragraph 5(a), with the exception of the amount of $7,952.41. Said amount of $7,952.41 constituted the minimum reserve required under said contract, and petitioner at no time had the right to the use, control, or disposition of said sum. Neither this amount, nor the additional amount set up by

the Commissioner, constitutes taxable income to petitioner during the year 1951.

(h) During the year 1951, petitioner used certain cars as service cars and demonstrator cars, and claimed as a deduction the amount of $5,281.81 as demonstrator expense. Said expenses were incurred as ordinary and necessary business expenses in the operation of petitioner's business, and are properly allowable in full as deductions for income tax purposes.

[fol. 7] (i) In 1951, petitioner used a Higgins boat, and a Lincoln Convertible automobile and 13 Mercury automobiles as service cars or demonstrators, and claimed a deduction for depreciation for all of said items in the total amount of $3,682.76. Said items were all used for business purposes throughout said year. The depreciation deduction claimed for the above items constitutes an ordinary and necessary business expense and is properly allowable in full.

(j) In 1951, petitioner sold said Lincoln Convertible automobile and five of the Mercury automobiles which he had used as demonstrators and service cars. Petitioner reported thereon a net long term capital gain of $778.30 and a gain of $1,072.88 on the sale of property other than capital assets. Commissioner determined that no gain or loss should be recognized on the sale of the Lincoln Convertible and that the gain on the sale of the other automobiles should be taxable at ordinary income rates; and as a net result of said adjustments, increased petitioner's income by $178.22. Petitioner properly reported the gain from the sale of said items, and the proposed adjustment of $178.22 is not proper.

Wherefore, petitioner prays that the court may hear this proceeding and disallow the proposed deficiencies and penalty.

Respectfully submitted,

E. CHAS. EICHENBAUM,
LEONARD L. SCOTT,
W. S. MILLER, JR.,
Attorneys for Petitioner,
Boyle Building,
Little Rock, Arkansas.

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* * * * *

Duly sworn to by Burl P. Glover, Jurat omitted in printing (all in italics)

* * * * *

[fol. 8] EXHIBIT "A" TO PETITION

U. S. Treasury Department
Internal Revenue Service
Regional Commissioner

Appellate Division
516 Oklahoma Natural Building
Oklahoma City 2, Oklahoma

Aug 6—1954

Mr. Burl P. Glover
1201 Main Street
Pine Bluff, Arkansas

Registered Mail

Dear Mr. Glover:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1949, December 31, 1950 and December 31, 1951 discloses a deficiency of $9,002.31 and penalty of $331.34 as shown in the attached statement.

[fol. 9] In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia, in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form in duplicate and return both copies to the Dallas Region, Appellate Division, 516 Oklahoma Natural Building, Oklahoma City, Oklahoma. The signing and filing of this form will expedite the closing of your returns by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours,

T. COLEMAN ANDREWS
Commissioner.

By William Biddle,
Associate Chief, Appellate Division.

Enclosures:
Statement
Form 1276
Agreement Form

Statement

Mr. Burl P. Glover
1201 Main Street
Pine Bluff, Arkansas

Tax Liability of Burl P. Glover and Cristeene E. Glover for the taxable years ended December 31, 1949, December 31, 1950 and December 31, 1951

[fol. 10]

Year	Income Tax Deficiency	Penalty Sec. 294(d)(2)
1949	$1,749.10	0.00
1950	5,041.33	0.00
1951	2,211.88	$331.34
Totals	$9,002.31	$331.34

In making this determination of your income tax liability, careful consideration has been given to the report of examination attached to letter mailed to you by the Director of Internal Revenue, Little Rock, Arkansas under date of February 18, 1953.

The Federal income tax returns filed by you and your former spouse for the taxable years ended December 31, 1949, December 31, 1950 and December 31, 1951 were jointly executed in the names of Burl P. Glover and Christine E. Glover with respect to 1949 and Burl P. Glover and Cristeene E. Glover with respect to 1950 and 1951. Inasmuch as the returns were jointly made and filed under the provisions of section 51(b) of the Internal Revenue Code, Burl P. Glover and Cristeene (Christine) E. Glover, each, are jointly and severally liable for the entire income tax liability due on the joint returns.

The above-stated penalty for the taxable year ended December 31, 1951 has been asserted in accordance with the provisions of section 294(d) (2) of the Internal Revenue Code.

Schedule 1

Adjustments to Net Income
Year Ended 12/31/49

Net income as disclosed by return			$11,993.63
Unallowable deductions and additional income:			
(a)	Finance Reserve income	$3,885.71	
(b)	Demonstrator expense decreased	840.00	
(c)	Depreciation deduction decreased	2,015.81	6,741.52
Net income adjusted			$18,735.15

[fol. 11]

Schedule 1-A.

Explanation of Adjustments

(a) In your return for the taxable year ended December 31, 1949 $8,026.85 in "Finance Reserve Income" was included in the net profit reported from the operation of Glover Motors, an individual proprietorship owned by Mr. Glover. The $8,026.85 reported represented $11,912.56 credited to the account of Mr. Glover on the books of the finance company less $3,885.71, a reserve of three percent of the outstanding notes held by the finance company. It has been determined that inasmuch as you reported income on an accrual basis, the entire $11,912.56 constituted taxable income for the year ended December 31, 1949. Net income has been increased, therefore, by an adjustment of $3,885.71.

(b) It has been determined that the deduction claimed in your return for the taxable year ended December 31, 1949 as demonstrator expense in the computation of net profit from business should be decreased from $1,823.02 to $983.02, an adjustment of $840.00, to eliminate from expense the portion applicable to personal use of the automobiles.

(c) In the computation of the net profit from business reported in your return for the taxable year ended December 31, 1949 a deduction of $2,973.65 was claimed and designated in the return as depreciation on "Service Cars." It has been determined that a Higgins Boat and two Lincoln and three Mercury automobiles, with respect to which $2,015.81 of the $2,973.65 in depreciation was claimed, were not depreciable property as that term is

defined in Section 29.23(1)-2 of Regulations 111. The Higgins Boat and the Lincoln Cosmopolitan Convertible automobile were not used for business purposes. The other Lincoln and three Mercury automobiles were demonstrators and were part of the inventories held for sale to customers in the ordinary course of the trade or business of the proprietorship, Glover Motors. Accordingly, it is held that $2,015.81 of the depreciation should be denied.

[fol. 12]

Schedule 2

Computation of Income Tax
Year ended 12/31/49

Net income adjusted (Schedule)		$18,735.15
Less: Exemption (3) x $600.00		1,800.00
Income subject to tentative tax		$16,935.15
One-half of income subject to tentative tax		$ 8,467.58
Tentative tax on $8,467.58		$ 2,118.98
Tax reduction:		
17% of $ 400.00	$ 68.00	
12% of 1,718.98	206.28	
Total tax reduction		274.28
Combined normal tax and surtax		$ 1,844.70
Combined normal tax and surtax multiplied by 2		$ 3,689.40
Income tax liability		$ 3,689.40
Income tax liability disclosed by return		1,940.30
Deficiency of income tax		$1,749.10

Schedule 3

Adjustments to Net Income
Year ended 12/31/50

Net income as disclosed by return			$39,350.43
Unallowable deductions and additional income:			
(a)	Finance reserve income	$7,601.07	
(b)	Demonstrator expense decreased	840.00	
(c)	Depreciation deduction decreased	2,159.97	
(d)	Personal expenditure denied	506.65	11,107.69
Total			$50,458.12
Additional deduction:			
(e)	Capital gains reduced		1,264.76
Net income adjusted			$49,193.36

Schedule 3-A

Explanation of Adjustments

(a) For the reason stated in adjustment (a), Schedule 1, of this statement, it has been determined that the "Finance Reserve Income" reported in your return for the taxable year ended December 31, 1950 should be increased from $8,126.29 to $15,727.36, an adjustment of $7,601.07.

(b) It has been determined that the deduction claimed in your return for the taxable year ended December 31, [fol. 13] 1950 as demonstrator expense in the computation of net profit from business should be decreased from $5,721.19 to $4,881.19, an adjustment of $840.00 to eliminate from expense the portion applicable to personal use of the automobiles.

(c) In the computation of the net profit from business reported in your return for the taxable year ended December 31, 1950, deductions totalling $2,569.23 were claimed for depreciation on property designated in the return as "Service Cars." For the reasons stated in adjustment (c), Schedule 1, of this statement, it has been determined that the Higgins Boat and Lincoln convertible automobile used for personal purposes and the Lincoln and nine Mercury automobiles used as demonstrators did not constitute depreciable property for Federal income tax purposes. Inasmuch as $2,159.97 of the depreciation claimed with respect to "Service Cars" was applicable to the boat and Lincoln and Mercury automobiles and consequently not allowable, net profit from business has been increased by an adjustment of $2,159.97.

(d) It has been determined that the cost of parts sold was overstated by $506.65, the purchase price of a combination radio phonograph charged to parts inventory in error. Since this item represents a personal expenditure, net income is increased by the amount of $506.65.

(e) In your return for the taxable year ended December 31, 1950 you reported a long-term capital gain of $746.00 and a gain on the sale of property other than capital assets of $308.38. The gain of $308.38 and $735.97 of the long-term capital gain, a total of $1,044.35, were applicable to the sale of the Lincoln and five of the Mercury automobiles discussed in adjustment (c) of this

schedule. Inasmuch as it has been determined that the automobiles were items of inventory held for sale to customers and not subject to depreciation, profit realized on the sale thereof was ordinary income and not capital gains. The exclusion from consideration of the depreciation charged against the cost of these automobiles in [fol. 14] the computation of gain or loss on the sale thereof resulted in a net loss of $220.41. Net income has been decreased therefore, by the sum of $1,044.35, the total gain reported, and $220.41, an adjustment of $1,264.76.

Schedule 4.

Computation of Alternative Tax
Year ended 12/31/50

One-half of income subject to tentative tax (Schedule 5)		$23,696.68
Less: One-half of excess of net long-term capital gain over short-term capital loss		5.03
Ordinary income		$23,691.65
Tentative tax on $23,691.65		$ 9,378.07
Tax reduction:		
13% of $ 400.00	$ 52.00	
9% of 8,978.07	808.03	860.03
Partial tax		$ 8,518.04
Partial tax multiplied by 2		$17,036.08
Add: Tax on long-term capital gain (50% of $10.06)		5.03
Alternative tax		$17,041.11

Schedule 5.

Computation of Income Tax
Year ended 12/31/50

Net income adjusted (Schedule 3)		$49,193.36
Less: Exemption (3) x $600.00		1,800.00
Income subject to tentative tax		$47,393.36
One-half of income subject to tentative tax		$23,696.68
Tentative tax on $23,696.68		$ 9,381.04
Tax reduction:		
13% of $ 400.00	$ 52.00	
9% of 8,981.04	808.29	
Total tax reduction		860.29
Combined normal tax and surtax		$ 8,520.75
Combined normal tax and surtax multiplied by 2		$17,041.50
Alternative tax, Schedule 4		$17,041.11
Income tax liability (lessor of ordinary and alternative tax)		$17,041.11
Income tax liability disclosed by return		11,999.78
Deficiency of income tax		$ 5,041.33

Schedule 6.

Adjustments to Net Income
Year ended 12/31/51

—Net income as disclosed by return		$31,130.16
Unallowable deductions and additional income:		
(a) Finance Reserve income	$ 351.34	
[fol. 15]		
(b) Demonstrator expense decreased	840.00	
(c) Depreciation deduction decreased	3,124.51	
(d) Adjustment for capital gains reported	178.22	4,494.07
Net income adjusted		$35,624.23

Schedule 6-A.

Explanation of Adjustments.

(a) For the reason stated in adjustment (a), Schedule 1, of this statement, it has been determined that the "Finance Reserve Income" reported in your return for the taxable year ended December 31, 1951 should be increased from $15,455.09 to $15,806.43, an adjustment of $351.34.

(b) It has been determined that the deduction claimed in your return for the taxable year ended December 31, 1951 as demonstrator expense in the computation of net profit from business should be decreased from $5,281.81 to $4,441.81, an adjustment of $840.00 to eliminate from expense the portion applicable to personal use of the automobiles.

(c) In the computation of the net profit from business reported in your return for the taxable year ended December 31, 1951, deductions totalling $3,682.76 were claimed for depreciation on property designated as "Service Cars and Demonstrators." For the reasons stated in adjustment (c), Schedule 1, of this statement, it has been determined that the Higgins Boat and the Lincoln Convertible automobile used for personal purposes and thirteen Mercury automobiles used as demonstrators did not constitute depreciable property for Federal income tax purposes. Inasmuch as $3,124.51 of the depreciation claimed with respect to "Service Cars and Demonstrators" was applicable to the boat and Lincoln and Mer-

cury automobiles and, consequently, not allowable, net profit from business has been increased by an adjustment of $3,124.51.

(d) In your return for the taxable year ended December 31, 1951, you reported a net long-term capital gain of $778.30 and a gain of $1,072.88 on the sale of [fol. 16] property other than capital assets. These gains represented the net profit realized on the sale of the Lincoln convertible and five of the Mercury automobiles discussed in adjustment (c) of this schedule.

Inasmuch as it has been determined that the Lincoln convertible was used for personal purposes only, no gain or loss has been recognized for Federal income tax purposes on the sale of the automobile. As stated in adjustment (e), Schedule 3-A of this statement, it has been determined that profit realized on the sale of automobiles used as demonstrators is taxable as ordinary income rather than capital gains. Accordingly, the net profit from business reported in your return has been increased by an adjustment of $178.22 that was computed as follows:

	Cost	Sales Price	Income Realized
1950 Mercury—No. 50 SL-37014	$ 1,803.43	$ 1,795.00	$ (8.43)
1951 Mercury—No. 51 SL-24177	1,959.09	2,495.00	535.91
1951 Mercury—No. 51 SL-13427	1,964.13	2,289.00	324.87
1951 Mercury—No. 51 SL-81152	1,953.66	2,295.00	341.34
1951 Mercury—No. 51 SL-56547	1,951.91	2,538.75	586.84
1951 Mercury—No. 51 SL-17834M	2,001.13	2,250.00	248.87
Totals	$11,633.35	$13,662.75	$2,029.40
Less income reported:			
Net long-term capital gain		$ 778.30	
Property other than capital assets		1,072.88	1,851.18
Increase in net income			$ 178.22

Schedule 7.

Computation of Income Tax
Year ended 12/31/51

Net income adjusted, Schedule 6	$35,624.23
Less: Exemption (3) x $600.00	1,800.00
Income subject to tentative tax	$33,824.23
One-half of income subject to tentative tax	$16,912.11
Tentative tax on $16,912.11	$ 5,761.18
Combined tax multiplied by 2	$11,522.36
Self-Employment tax (Schedule C of return)	81.00
Income tax liability	$11,603.36
Income tax liability disclosed by return	9,391.48
Deficiency of income tax	$ 2,211.88

[fol. 17]

Penalty.

Penalty under Section 294(d)(2)—(Exhibit A)	$ 331.34

Exhibit A.

Computation of Addition to Tax for Substantial Underestimation of Declaration of Estimated Tax Under Section 294(d)(2) of the Internal Revenue Code

Year ended 12/31/51

(a)	Income tax liability, Schedule 7		$11,522.36
	80% of above		$ 9,217.89
	Less: Withholding tax actually withheld	$ 0.00	
	Estimated tax	6,000.00	6,000.00
	Tentative addition to tax		$ 3,217.89
(b)	Income tax liability, Schedule 7		$11,522.36
	Less: Withholding tax actually withheld	$ 0.00	
	Estimated tax	6,000.00	6,000.00
Difference			$ 5,522.36
Tentative addition to tax (5% of $5,522.36)			$ 331.34
Penalty (lesser of (a) and (b))			$ 331.34

IN THE TAX COURT OF THE UNITED STATES

ANSWER—Filed November 26, 1954

Comes now the Commissioner of Internal Revenue, by his attorney, Daniel A. Taylor, Chief Counsel, Internal

Revenue Service, and for answer to the petition of the above-named taxpayer, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits the allegations contained in paragraph 3 of the petition.

4. (a) through (k) incl. Denies that the Commissioner committed the errors alleged in paragraph 4 and [fol. 18] subparagraphs (a) through (k), inclusive, of paragraph 4 of the petition.

5(a) through (j) inclusive. Admits that during all of the years involved, petitioner operated an automobile sales business in Arkansas, but denies the remaining allegations contained in paragraph 5(a) through (j) inclusive of the petition.

6. Denies generally and specifically each and every allegation contained in the petition not hereinbefore admitted, qualified or denied.

Wherefore, it is prayed that the Commissioner's determination be approved.

DANIEL A. TAYLOR,
Chief Counsel,
Internal Revenue Service.

Of Counsel:

James L. Backstrom,
Regional Counsel;

E. G. Sievers,
Asst. Regional Counsel;

John P. Higgins,
Special Attorney,
Internal Revenue Service.

IN THE TAX COURT OF THE UNITED STATES

Little Rock, Arkansas,

TRANSCRIPT OF PROCEEDINGS—Thursday, December 5, 1956.

The above-entitled matter came on for hearing, pursuant to notice, at 3:30 o'clock, p.m.

Before:

The Honorable J. Gregory Bruce.

APPEARANCES:

W. S. Miller, Jr., Esq., Boyle Building, Little Rock, Arkansas, on behalf of the Petitioner.

Robert B. Wallace, Esq., on behalf of the Respondent.

[fol. 19] The Clerk: Docket Number 55083, Burl P. Glover.

Will Counsel please state your appearances.

Mr. Miller: W. S. Miller, Jr., for the Petitioner.

Mr. Wallace: For the Respondent, Robert B. Wallace.

COLLOQUY BETWEEN COURT AND COUNSEL.

Your Honor, we have a Stipulation of Facts in the case, with Exhibit 1-A attached, and I would like at this time to submit the Stipulation of Facts.

The Court: The Stipulation of Facts with Exhibit 1-A attached is received.

Mr. Wallace: Your Honor, I understand that there will not be any case on the part of the Petitioner, and I would like enter some Exhibits. I did not have the facilities to have them photostated and I have attached the originals to the Stipulation of Facts for the reason that I think we will withdraw them.

The Court: Let me ask the parties this: Neither one of you has asked for an opening statement, and I will not insist upon it since you are stipulating the facts.

If I understand this case from a hurried glance at it, it is one involving the question—it is an automobile dealer's case?

Mr. Miller: Yes, sir.

The Court: And it is one of these so-called finance reserve cases.

Mr. Miller: That will be the only issue remaining after the Stipulation has been received.

The Court: The other issues have been stipulated out?

Mr. Miller: Yes, sir.

[fol. 20] The Court: Then, I would like to look at the Stipulation before we close the case to see how tight your stipulation is.

Mr. Wallace: At this time, I would like to offer the 1949 income tax return as Respondent's Exhibit B.

The Court: It will be marked for identification and received in evidence as Respondent's Exhibit B.

(Respondent Exhibit B was marked for identification and was received in evidence.)

Mr. Wallace: The Respondent would like to offer in evidence the 1950 income tax return of the Petitioner as Exhibit C.

The Court: It will be received in evidence and marked for identification as Respondent's Exhibit C.

(Respondent's Exhibit C was marked for identification and was received in evidence.)

Mr. Wallace: The Respondent would like to offer in evidence the 1951 income tax return of the Petitioner as Exhibit D.

The Court: It will be received in evidence and marked for identification as Respondent's Exhibit D.

(Respondent's Exhibit D was marked for identification and was received in evidence.)

Mr. Wallace: If your Honor please, the Respondent requests permission to withdraw the originals of Exhibits B, C, and D, and substitute photostatic copies therefor.

The Court: Leave is granted to withdraw the originals and substitute photostatic copies therefor.

Mr. Wallace: That is the case, your Honor.

The Court: The case will be taken under submission. How much time do you want for briefs?

[fol. 21] Mr. Miller: Your Honor, we would like to ask for seventy-five days for simultaneous briefs. I have one case on a February calendar, and the sixty days will just about fall within that time and it would be a little inconvenient.

The Court: I suppose we will allow seventy-five days

for the simultaneous briefs and then thirty days for reply briefs.

The Clerk: February 21, 1957 for Simultaneous briefs and March 25 for reply briefs.

The Court: If there is nothing further, the case is submitted, and the hearing is closed.

(Whereupon, at 3:45 o'clock p.m., the hearing in the above entitled matter was closed.)

STIPULATION OF FACTS—Filed December 5, 1956.

It is hereby stipulated and agreed by and between the parties hereto, by their respective attorneys, that the following facts shall be considered as true, provided, however, that either party may introduce other and further evidence not inconsistent with the facts herein.

1. During all of the years involved, petitioner operated a retail automobile agency known as Glover Motors, a sole proprietorship. The books of account were kept on a calendar year accrual basis, and income tax returns filed on the accrual basis for all years involved.

2. During all of the years involved, petitioner maintained a financing agreement with Universal C.I.T. Credit Corporation for the financing of new and used car sales. A copy of said agreement is attached hereto and made a part of this stipulation, designated as joint Exhibit 1-A.

3. During the years involved, Universal C.I.T. Credit Corporation maintained a reserve account on its books [fol. 22] in the name of petitioner, and petitioner maintained on his own books an account or accounts reflecting the credits accruing on the assignment of contracts to the finance company under the terms of said agreement.

4. At the beginning of 1949, the finance reserve account balance carried forward was $2,702.15. Credits by the finance company in 1949 totalled $9,210.41. Three percent of customer notes outstanding held by the finance company at December 31, 1949 equalled $3,885.71.

5. Petitioner computed the finance reserve income reported in his income tax return for 1949 as follows:

Credits carried forward from 1948		$ 2,702.15
Credits to reserve account—1949		9,210.41
		$11,912.56
Less:	Portion of reserve not available for withdrawal—3% of outstanding notes	3,885.71
	Reported per tax return	$8,026.85

6. Credits to the reserve account by the finance company in 1950 totalled $15,727.36. Three percent of customer notes outstanding at December 31, 1950 equalled $7,601.07.

7. Petitioner computed the finance reserve income reported in his income tax return in 1950 as follows:

Credits carried forward from 1949		$ None
Credits to reserve account—1950		15,727.36
Less:	Portion of reserve not available for withdrawal—3% of outstanding notes	7,601.07
Reported per tax return		$ 8,126.29

8. Petitioner concedes that $3,885.71, excluded from income in 1949, should have been carried forward to 1950 under the method of computation used by petitioner, so that the amount reported as finance reserve income in 1950 under petitioner's method of computation should have been $12,012.00.

[fol. 23] 9. Credits to the reserve account in 1951 totalled $15,806.43. Three percent of outstanding notes at December 31, 1951 equalled $7,952.41.

10. Petitioner computed the finance reserve income reported in his income tax return in 1951 as follows:

Credits carried forward from 1950		$ 7,601.07
Credits to reserve account—1951		15,806.43
		23,407.50
Less:	Portion of reserve not available for withdrawal—3% of outstanding notes	7,952.41
Reported per tax return		$15,455.09

11. Amounts claimed in petitioner's 1949, 1950 and 1951 income tax returns for demonstrator expense and portions thereof properly allowable are as follows:

Year	Claimed In Return	Amount Allowable
1949	$1,823.02	$1,298.02
1950	5,721.19	4,756.19
1951	5,281.81	4,756.81

12. Amounts claimed in petitioner's 1949, 1950 and 1951 tax returns for depreciation of "Service Cars" and amounts properly allowable for depreciation of such assets as follows:

Year	Service Car Depreciation Claimed	Amount Allowable
1949	$2,973.65	$2,536.42
1950	2,569.23	1,973.93
1951	3,682.76	2,422.60

13. Capital gains and gains on the sale of property other than capital assets as reported in petitioner's 1950 and 1951 returns and the correct amounts of such gains are as follows:

[fol. 24]

Year	Taxable 50% of Long-Term Capital Gain Per Return	Correct
1950	$ 746.00	$346.63
1951	778.30	535.22

Year	Taxable Gain of Property Other Than Capital Assets Per Return	Correct
1950	$ 308.38	$238.14
1951	1,072.88	969.98

W. S. MILLER, JR.
Counsel for Petitioner

JOHN POTTS BARNES
Chief Counsel
Internal Revenue Service
Counsel for Respondent

EXHIBIT 1-A TO STIPULATION OF FACTS.

Retail Protection Agreement

For

Automobile Dealers

Pine Bluff, Arkansas
(City) (State)

April 6, 1950
(Date)

To Universal C.I.T. Credit Corporation:

1. You propose to buy from us, on the basis stated in this agreement, paper acceptable to you covering new and used cars; except as provided in this agreement said paper will be assigned to you without recourse as to the customer's obligation of payment, except that paper covering commercial cars used for long distance hauling, commercial cars of more than two tons capacity, busses, [fol. 25] cars used for taxi, jitney, "drive-yourself" service, or cars sold to relatives or employees will bear our full recourse endorsement; in such cases you may make any necessary correction in our endorsement and paragraphs 2 and 3 shall not apply.

2. We will purchase from you each repossessed or recovered car tendered at our place of business within 90 days after maturity of the earliest instalment still unpaid. The purchase price payable on demand shall be the unpaid balance due on the car, limited as stated in paragraph 3. Until paying you we will store the car at our risk and expense and as your property and will deliver it to you on demand.

3. We shall have no responsibility as to converted or confiscated cars until they are repossessed or recovered and tendered as above. You will allow us the cost of repairing actual direct collision damage necessitating repossession, the allowance is not to exceed the unpaid balance on the car after deducting both the "as is" value and the amount of any deferred certificate or other special hold-back relating to the car. Where the resale value

of the repaired car (excluding overhead and salesman's commissions) exceeds the unpaid balance, the excess will be deducted from the collision allowance.

4. Your rate charts will include, for our protection, reserves as outlined in your reserve arrangement effective at the time paper is purchased by you. No reserves are to be set up in respect of short term note, demonstrator or other special plans announced by you from time to time, except as may be agreed upon hereafter in writing. Three times in each twelve-month period, if we are not then indebted to you, you will pay us our accumulated reserves in excess of 3% of the then aggregate unpaid balances on paper purchased from us. If you stop buying our paper, you may hold and apply all reserves until liquidation of all paper purchased from us is completed.

5. If you refund any part of the service charge because an account is prepaid, we agree to pay you the same percentage of all reserves credited to or paid us on [fol. 26] the account as the amount of service refund bears to the amount of the original charge exclusive of insurance premium.

6. If, in reselling repossessed passenger cars which we purchase from you, covered by paper sold to you in any twelve-successive-month period, we incur a loss (excluding overhead and salesman's commissions) in excess of 3% of the volume of our paper sold you during said period, plus the amount of our reserves for said period, you shall reimburse us for such excess, provided we have resold the cars for their reasonable value within 90 days after delivery to us. We shall credit total profits on resales against total net losses. This paragraph applies only (a) if we have sold you paper covering at least 100 cars during such period, (b) if we perform all of our obligations to you, and (c) if, before incurring such excess losses, we give you written notice of the offered price of each car and the opportunity to resell it.

7. We will be under full recourse liability to you on the assignment of paper covering equipment other than described in paragraph 1 above notwithstanding the language of such assignment or if in connection with any transaction covering equipment described in paragraph

1 we make any settlement with a customer without your written consent, if we disclose any part of this agreement to the customer, if we breach any provision of the assignment to you, and on paper which bears or in connection with which you receive our guaranty. In any such cases you may make any necessary changes in our endorsements or assignments to express such liability. If we are in default to you under this or any other agreement or obligation at the time of any repossession, cars may be tendered by registered mail notice sent to the last address shown by your records, instead of as provided in paragraphs 2 and 3 above, if we are not then doing business as a going concern, tender of repossessed cars is waived. In case we fail to purchase repossessed cars we will be responsible for any deficiency incurred by you in the resale of such repossessed cars at public or private sale held with or without notice, at which you may purchase.

[fol. 27] 8. This agreement shall apply to all paper hereafter sold to you as above stated, irrespective of transfers between or extensions of time to customers and until the paper is liquidated, unless otherwise specifically agreed in writing with respect to the particular paper. No waiver or change of any part of this agreement shall be binding on you unless evidenced by writing signed by one of your officers.

9. The purchase of paper by you from us shall constitute acceptance by you of this agreement, which shall cover all such purchases. This agreement shall inure to and bind our respective successors and assigns and any present and future company affiliated with you which may transact business hereunder.

This is sworn to be a true copy of the original.

A. W. PRICE,
Branch Manager.

GLOVER MOTORS,
(Corporate, Individual or Firm Name)
By /s/ B. P. Glover,
Its Owner
(Title of Officer of Corporation, if owner or partner, state which)

Signed before me by A. W. Price on 19th day of June, 1954.

B. E. SANDERS,
Notary Public.

My Commission Expires Sept. 25, 1954.
7-357A (Rev. 6-49)

T. C. Memo. 1957-45

In the Tax Court Of The United States

(Title Omitted)

Memorandum Findings of Fact and Opinion—Filed March 18, 1957.

[fol. 28] Held: Amounts credited by a finance company to the "dealer's reserve" account of petitioner, an accrual basis automobile dealer, were income to petitioner in the year credited.

W. S. Miller, Jr., Esq., for the petitioner.

Robert B. Wallace, Esq., for the Respondent.

Bruce, Judge: Respondent determined deficiencies in petitioner's income tax for the years 1949, 1950, and 1951, and addition to tax for the year 1951, as follows:

Year	Deficiency	Addition to Tax Sec. 294(d)(2)
1949	$1,749.10	-0-
1950	5,041.33	-0-
1951	2,211.88	$331.34

Of the several adjustments and determinations made by respondent, only one is in dispute. The sole issue is whether the entire amount credited to petitioner's "dealer's reserve" with a finance company during each of the taxable years was income to petitioner in the year of accrual.

All of the facts were stipulated and are so found and incorporated herein by this reference.

During all of the years involved, petitioner operated a retail automobile agency known as Glover Motors, a sole proprietorship. The books of account were kept on a calendar year accrual basis, and income tax returns filed on an accrual basis for all years involved. Petitioner and his wife filed joint income tax returns for each of the taxable years with the collector of internal revenue for the district of Arkansas.

During all of the years involved, petitioner maintained a financing agreement with Universal C.I.T. Credit Corporation for the financing of new and used car sales. The agreement provided as follows:

To Universal C.I.T. Credit Corporation:

1. You propose to buy from us, on the basis stated in this agreement, paper acceptable to you covering new and [fol. 29] used cars; except as provided in this agreement said paper will be assigned to you without recourse as to the customer's obligation of payment, except that paper covering commercial cars used for long distance hauling, commercial cars of more than two tons capacity, busses, cars used for taxi, jitney, "drive yourself" service, or cars sold to relatives or employees will bear our full recourse endorsement; in such cases you may make any necessary correction in our endorsement and paragraphs 2 and 3 shall not apply.

2. We will purchase from you each repossessed or recovered car tendered at our place of business within 90 days after maturity of the earliest instalment still unpaid. The purchase price payable on demand shall be the unpaid balance due on the car, limited as stated in paragraph 3. Until paying you we will store the car at our risk and expense and as your property and will deliver it to you on demand.

3. We shall have no responsibility as to converted or confiscated cars until they are repossessed or recovered and tendered as above. You will allow us the cost of repairing actual direct collision damage necessitating repossession; the allowance is not to exceed the unpaid balance on the car after deducting both the "as is" value and the amount of any deferred certificate or other special holdback relating to the car. Where the resale value of the repaired car (excluding overhead and salesman's commissions) exceeds the unpaid balance, the excess will be deducted from the collision allowance.

4. Your rate charts will include, for our protection, reserves as outlined in your reserve arrangement effective at the time paper is purchased by you. No reserves are to be set up in respect of short term note, demonstrator or other special plans announced by you from time to time, except as may be agreed upon hereafter in writing. Three times in each twelve-month period, if we are not then indebted to you, you will pay us our accumulated reserves in excess of 3% of the then aggregate unpaid balances on paper purchased from us. If you stop [fol. 30] buying our paper, you may hold and apply all reserves until liquidation of all paper purchased from us is completed.

5. If you refund any part of the service charge because an account is prepaid, we agree to pay you the same percentage of all reserves credited to or paid us on the account as the amount of service refund bears to the amount of the original charge exclusive of insurance premium.

6. If, in reselling repossessed passenger cars which we purchase from you, covered by paper sold to you in any twelve-successive-month period, we incur a loss (excluding overhead and salesman's commissions) in excess of 3% of the volume of our paper sold you during said period, plus the amount of our reserves for said period, you shall reimburse us for such excess, provided we have resold the cars for their reasonable vaule within 90 days after delivery to us. We shall credit total profits on resales against total net losses. This paragraph applies only (a) if we have sold you paper covering at least 100 cars during such period, (b) if we perform all of our

obligations to you, and (c) if, before incurring such excess losses, we give you written notice of the offered price of each car and the opportunity to resell it.

7. We will be under full recourse liability to you on the assignment of paper covering equipment other than described in paragraph 1 above notwithstanding the language of such assignment or if in connection with any transaction covering equipment described in paragraph 1 we make any settlement with a customer without your written consent, if we disclose any part of this agreement to the customer, if we breach any provision of the assignment to you, and on paper which bears or in connection with which you receive our guaranty. In any such cases you may make any necessary changes in our endorsements or assignments to express such liability. If we are in default to you under this or any other agreement or obligation at the time of any repossession, cars may be tendered by registered mail notice sent to the last address known by your records, instead of as provided in para- [fol. 31] graphs 2 and 3 above; if we are not then doing business as a going concern, tender of repossessed cars is waived. In case we fail to purchase repossessed cars we will be responsible for any deficiency incurred by you in the resale of such repossessed cars at public or private sale held with or without notice, at which you may purchase.

8. This agreement shall apply to all paper hereafter sold to you as above stated, irrespective of transfers between or extensions of time to customers and until the paper is liquidated, unless otherwise specifically agreed in writing with respect to the particular paper. No waiver or change of any part of this agreement shall be binding on you unless evidenced by writing signed by one of your officers.

9. The purchase of paper by you from us shall constitute acceptance by you of this agreement, which shall cover all such purchases. This agreement shall inure to and bind our respective successors and assigns and any present and future company affiliated with you which may transact business hereunder.

During the years involved, Universal C.I.T. Credit Corporation maintained a reserve account on its books in the name of petitioner, and petitioner maintained on his own books an account or accounts reflecting the credits accruing on the assignment of contracts to the finance company under the terms of said agreement.

At the beginning of 1949, the finance reserve account balance carried forward was $2,702.15. Credits by the finance company in 1949 totalled $9,210.41. Three per cent of customer notes outstanding held by the finance company at December 31, 1949 equalled $3,885.71.

Petitioner computed the finance reserve income reported in his income tax return for 1949 as follows:

Credits carried forward from 1948	$ 2,702.15
Credits to reserve accounts—1949	9,210.41
	$11,912.56
Less: Portion of reserve not available for withdrawal—3% of outstanding notes	3,885.71
Reported per tax return	$ 8,026.85

[fol. 32] Credits to the reserve account by the finance company in 1950 totalled $15,727.36. Three per cent of customer notes outstanding at December 31, 1950 equalled $7,601.07.

Petitioner computed the finance reserve income reported in his income tax return in 1950 as follows:

Credits carried forward from 1949	None
Credits to reserve account—1950	$15,727.36
Less: Portion of reserve not available for withdrawal—3% of outstanding notes	7,601.07
Reported per tax return	$ 8,126.29

Petitioner concedes that $3,885.71 excluded from income in 1949, should have been carried forward to 1950 under the method of computation used by petitioner, so that the amount reported as finance reserve income in 1950 under petitioner's method of computation should have been $12,012.

Credits to the reserve account in 1951 totalled $15,806.43. Three per cent of outstanding notes at December 31, 1951 equalled $7,952.41.

Petitioner computed the finance reserve income reported in his income tax return in 1951 as follows:

Credits carried forward from 1950	$ 7,601.07
Credits to reserve account—1951	15,806.43
	23,407.50
Less: Portion of reserve not available for withdrawal—3% of outstanding notes	7,952.41
Reported per tax return	$15,455.09

For the taxable years petitioner reported the following amounts of net profit from the operation of his automobile agency and total net profit from all sources:

Year	Profit on Operations	Total Net Profit
1949	$ 5,308.31	$15,285.99
1950	28,692.69	39,296.05
1951	12,653.49	31,923.73

[fol. 33] Petitioner deducted the following amounts of bad debt expense for the taxable years:

Year	Bad Debt Expense
1949	$1,897.74
1950	7,393.20
1951	4,167.05

Respondent determined that the portion of the reserve withheld by Universal C.I.T. Credit Corporation in each of the taxable years was includible in petitioner's income for those years.

This Court has consistently held that amounts credited by a financing institution to the "dealer's reserve" account of an accrual basis automobile or trailer dealer are income to the dealer in the year credited. See Shoemaker-Nash, Inc., 41 B.T.A. 417 (1940); Blaine Johnson, 25 T.C. 123, revd. (C.A. 4, 1956), 233 F. 2d 952; Albert M. Brodsky, 27 T.C. . . . , (Oct. 31, 1956); Texas Trailercoach, Inc., 27 T.C. . . . . (Dec. 21, 1956); West Pontiac, Inc., 27 T. . . . . (Jan. 31, 1957). Respondent contends

that the facts in the instant case bring it within our previous decisions. Petitioner argues that he had no right to the portion of the reserve withheld by the finance company because the company could have successfully resisted any claim to those amounts.

After thoroughly reviewing once again the pertinent authorities dealing with this problem, we conclude that the prior decisions of this Court correctly state the law applicable to the facts here presented. We therefore hold that the portion of dealer's reserve which was withheld by Universal C.I.T. Corporation in each of the years involved was includible in petitioner's taxable income for such years.

Among the authorities cited by petitioner is Johnson vs. Commissioner, (C.A. 4, 1956), 233 F. 2d 952, in which a view contrary to the holding herein was expressed by the Circuit Court of Appeals. With due deference to that Court, we nevertheless feel compelled to adhere to our [fol. 34] previous decisions, and we therefore respectfully decline to follow Johnson vs. Commissioner, supra. See Arthur L. Lawrence, 27 T.C. . . . (Jan. 25, 1957).

Decision will be entered under Rule 50.

Seal
The Tax Court of
the United States

In Tax Court of The United States
Washington

(Title Omitted)

Decision June 5, 1957.

Pursuant to the Memorandum Findings of Fact and Opinion of this Court filed March 18, 1957, the respondent, on June 3, 1957, filed his computation of deficiencies under Rule 50 of the Court's Rules of Practice. The petitioner having concurred in such computation, it is

Ordered and Decided: That there are deficiencies for the years and in the amounts as follows:

Year	Deficiency	Addition to Tax Sec. 294(d)(2)
1949	$1,216.28	
1950	4,446.67	
1951	859.44	$250.20

Enter:

Entered Jun. 5-1957.

J. GREGORY BRUCE,
Judge.

Seal
The Tax Court of
the United States

(fol. 35) In Tax Court of The United States
Washington

(Title Omitted)

ORDER AMENDING DECISION August 26, 1957.

For good cause shown, it is

Ordered: That the decision in this cause entered on June 5, 1957 is amended by changing the first two lines of the second paragraph to read "Ordered and Decided: That there are deficiencies in income tax and additions to tax, Internal Revenue Code of 1939, for the years and in the amounts as follows:"

It is Further Ordered: That the Decision entered June 5, 1957 remain the same in all other respects.

J. GREGORY GRUCE,
Judge.

Seal
The Tax Court of
the United States

Dated: August 26, 1957.

In The Tax Court of The United States

(Title Omitted)

PETITION FOR REVIEW—Filed August 27, 1957.

To The United States Court Of Appeals For The Eighth Circuit:

[fol. 36] Comes the Petitioner, by his counsel, and prays a review of the decision of the Tax Court of the United States entered June 5, 1957, in the above captioned action.

As grounds for this proceeding, Petitioner states:

1. Petitioner is an individual, residing in Pine Bluff, Arkansas. During all of the years involved in this proceeding, Petitioner resided in the State of Arkansas, maintained a retail automobile agency in Pine Bluff, Arkansas, and filed Federal income tax returns in Arkansas.

2. The controversy involved a proceeding for redetermination of deficiencies in income tax, and asserted penalty, as follows:

Year	Deficiency	Addition to Tax Sec. 294(d)(2)
1949	$1,216.28	—
1950	4,446.67	—
1951	859.44	$250.20

3. The controversy arises out of the inclusion in income by the Commissioner of Internal Revenue, in each of the years involved, of amounts credited by a finance company to the "dealer's reserve" account of Petitioner maintained on the books of said finance company, which amounts Petitioner excluded from income on the ground that said amounts were not subject to withdrawal, use or control of the Petitioner during the respective years involved. Other issues raised in the original pleadings have been settled by stipulation between the parties, and are not in controversy on this appeal.

4. The decision of the Tax Court of the United States entered on June 5, 1957 adjudged the above mentioned deficiencies in accordance with its opinion filed March 18, 1957.

5. Petitioner, on appeal, intends to rely upon the following point:

The Court erred in determining that the amounts credited by the finance company to the "dealer's reserve" account of Petitioner on the books of the finance company, [fol. 37] in each of the years involved, constituted income to Petitioner for the respective years in the full amount credited, without any allowance for the 3% reserve (based on outstanding notes) provided by the agreement with the finance company.

Wherefore, Petitioner prays that the Court review the decision and grant the relief prayed in the original pleadings below, with respect to "dealer's reserve" account.

E. CHAS. EICHENBAUM,
LEONARD L. SCOTT,
W. S. MILLER, JR.

* * * *

Clerk's Certificate to foregoing transcript, omitted in printing.

[fol. 38] IN UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 15,877

Burl P. Glover, Petitioner,

vs.

Commissioner of Internal Revenue, Respondent.

Petition to Review Decision of The Tax Court of the United States.

W. S. Miller, Jr. (E. Chas. Eichenbaum, Leonard L. Scott and Eichenbaum, Scott & Miller were with him on the brief) for Petitioner.

Joseph F. Goetten, Attorney, Department of Justice, (Charles K. Rice, Assistant Attorney General, Lee A. Jackson, Robert A. Anderson and Carolyn R. Just, Attorneys, Department of Justice, on the brief), for Respondent.

Before GARDNER, Chief Judge, and JOHNSEN and VAN OOSTERHOUT, Circuit Judges.

OPINION—April 23, 1958

GARDNER, Chief Judge.

This matter is before us on taxpayer's petition to review an adverse decision of the Tax Court. The taxes involved are those allegedly accruing in the taxable years 1949, [fol. 39] 1950 and 1951. During the period here involved taxpayer was engaged in the business of selling motor vehicles and was operating under the trade name of Glover Motors. In the course of his business he sold cars on

credit receiving notes of purchasers representing the balance due on the purchase price. These notes he sold and transferred to a finance company known in the record as the Universal C.I.T. Credit Corporation. The sales of these notes to the finance company were made pursuant to a written contract prepared by the finance company. Certain classes of these notes were transferred without recourse while others were transferred with full recourse. On transfer and delivery of the notes the taxpayer received 97% of the face value of the notes and the finance company withheld 3% and this transaction was evidenced on the books of the finance company by an entry of this 3% withheld in an account called the dealer's reserve account. A similar entry was reflected in the books of the taxpayer. The contract between the parties with reference to this dealer's reserve account provided that three times in each twelve months period the finance company would, if the dealer were not then indebted to it, pay to the dealer the accumulated reserves in excess of 3% of the then aggregate unpaid balances on notes purchased from the dealer, but that if the finance company should stop buying notes from the dealer it might hold and apply all reserves until liquidation of all paper was completed.

At the end of the taxable year 1949 there was withheld by the finance company the sum of $3,885.71 in the dealer's reserve account, at the end of the taxable year 1950 there was withheld by the finance company the sum of $7,601.07, and at the end of the taxable year 1951 there was withheld by the finance company the sum of $7,952.41 in the dealer's reserve account. These reserves withheld [fol. 40] by the finance company represented 3% of customers' notes outstanding at the close of each respective taxable year. There amounts had not been received by taxpayer during the taxable year and were not reported by him as part of his income for the respective years, but taxpayer reported all sums paid to him from the reserve account during each year. The Commissioner, however, determined a deficiency in taxpayer's income taxes for the respective years by including these funds withheld by the finance company as a part of taxpayer's income. The

single issue presented by this appeal is whether the funds withheld in the dealer's reserve account at the end of each respective taxable year were taxable income to taxpayer in the respective year in which they were withheld by the finance company in the dealer's reserve account.

Taxpayer kept his books on the accrual basis and filed his income tax returns on the accrual basis for all years involved. He contended before the Tax Court, and he renews the contention here, that these funds withheld by the finance company were not taxable because he had neither possession nor control of, nor right to receive the 3% withheld during the taxable year. The question here involved can no longer be considered as one of first impression. As said by the Supreme Court in *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182:

> "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues."

In the instant case there was never a time in the taxable years at which the taxpayer had a right to demand or receive payment of the funds withheld. As said by the Su- [fol. 41] preme Court in *MacLaughlin v. Alliance Insurance Co.*, 286 U.S. 244:

> "Realization of the gain is the event which calls into operation the taxing act * * *."

In its opinion in the case at bar the Tax Court conceded that the decision of the Fourth Circuit in *Johnson v. Commissioner of Internal Revenue*, 4 Cir., 233 F.2d 952, supported the contention of the taxpayer in the instant case but contended that the decision was erroneous, and the Tax Court relied to some extent on its own decision in *Texas Trailercoach, Inc. v. Commissioner*, 27 T.C. 575. That decision, however, has since the trial of this case in the Tax Court been reversed by the Fifth Circuit, *Texas Trailercoach, Inc. v. Commissioner of Internal Revenue*, 5 Cir., 251 F.2d 395. The Fifth Circuit follows the teach-

ing of *Johnson* v. *Commissioner of Internal Revenue*, supra. The facts in *Johnson* v. *Commissioner of Internal Revenue*, supra, are strikingly similar to the facts in the case at bar and we think the case is directly in point on the issue here involved. In that case, as in the instant case, there was a withholding of funds that might ultimately be paid to the taxpayer. In the course of the opinion the court stated the applicable rule as follows:

> "Until the right to an amount becomes accruable through fixation of the right to receive, the taxpayer is under no obligation to return it as income. Otherwise, he would be required to pay a tax on income which he might never have a right to receive."

Again, the court said:

> "Taxation is a practical matter; the substance of what is done and not the form must govern."

Mere matters of bookkeeping may not obscure the substance of what is done.

[fol. 42] In the very recent decision of the Fifth Circuit in *Texas Trailercoach, Inc.* v. *Commissioner of Internal Revenue*, supra, the facts cannot be differentiated from the basic facts in the case at bar. In that case there was a withholding of funds ultimately, under certain contingencies, to become due the taxpayer but they were not actually received and taxpayer was not entitled to receive them in the taxable year. In the course of the opinion the court, referring to the funds withheld by the finance company, said:

> "There is no doubt that, from a lay or purely practical point of view, the five per cent did not become fixed or ascertainable and therefore accrue in the taxable year in question."

By analogy the doctrine announced by the Third Circuit in *Keasbey & Mattison Co.* v. *United States*, 3 Cir., 141 F.2d 163, is here apposite. In that case there was a withholding of funds by a finance company. In the course of the opinion in that case it is said, inter alia:

> "Applying the foregoing principles to the facts of the instant case, it follows that no part of the reserve

fund was accruable as an asset to the plaintiff during the taxable year. Certainly nothing was payable to the plaintiff by way of reserve excess, for there was none. At no time was the reserve much more than half the amount of ten per cent of the notes discounted by the Finance Company (the amount of reserve necessary before there could be any excess payable to the plaintiff). And, as to what was actually in the reserve, the plaintiff's right thereto was subject to the payment therefrom of all notes, discounted by the Finance Company, which should become delinquent for a period of sixty days or more, and all charges due the Finance Company. Whether the plaintiff would ever acquire a fixed right to receive anything from the reserve fund was contingent and unascertainable throughout the taxable year."

[fol. 43] In the instant case there was no time during either of the years in question at which the taxpayer could have fixed any definite amount to which he was or would become entitled. Under his contract with the finance company there were at least four specific unperformed obligations of taxpayer, the nonperformance of any one of which would have changed the amount of the reserve withheld to which he might claim a right in the future, namely: (a) obligation to purchase repossessed cars at amount equal to unpaid note, (b) obligation to share portion of refund of service charge, if any, (c) obligation under the full recourse liability paragraph and (d) obligation to make good any deficiency incurred in resale of repossessed cars.

Under facts so strikingly similar in their essential features to the facts in the instant case as to be indistinguishable the Fourth and Fifth Circuits have held that the funds here sought to be included in taxpayer's income for the respective years involved were not taxable for those years. We are in full accord with the decisions referred to. It follows that the decision of the Tax Court is reversed.

[fol. 44] IN UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 15877—September Term, 1957.

Burl P. Glover, Petitioner,

vs.

Commissioner of Internal Revenue.

Petition to Review Decision of The Tax Court of the United States.

JUDGMENT—April 23, 1958

This cause came on to be heard on the petition to review the decision of The Tax Court of the United States entered June 5, 1957, determining that there are deficiencies in the income taxes of the petitioner for the years 1949, 1950 and 1951, and was argued by counsel.

On Consideration Whereof, It is now here Ordered and Adjudged by this Court that the decision of the said Tax Court in this cause be, and the same is hereby, reversed.

And it is further Ordered and Adjudged by this Court that this cause be, and the same is hereby, remanded to the said Tax Court of the United States for proceedings consistent with the opinion of this Court this day filed herein.

April 23, 1958.

* * * *

[fol. 45] Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 46] SUPREME COURT OF THE UNITED STATES

No. 381, October Term, 1958

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

BURL P. GLOVER

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI—July 11, 1958

UPON CONSIDERATION of the application of counsel for petitioner,

IT IS ORDERED that the time for filing petition for writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including September 20th, 1958.

/s/ Hugo L. Black
Associate Justice of the Supreme Court of the United States.

Dated this 11th day of July 1958.

[fol. 47] SUPREME COURT OF THE UNITED STATES

No. 381, October Term, 1958

(Title Omitted)

ORDER ALLOWING CERTIORARI—November 10, 1958

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Eighth Circuit is granted. The case is consolidated with No. 380 and a total of two hours is allowed for oral argument.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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SUPREME COURT, U. S.

TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1958

No. 512

CLIFTON E. BAIRD AND VIOLET L. BAIRD,
PETITIONERS,

vs.

COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

PETITION FOR CERTIORARI FILED NOVEMBER 12, 1958
CERTIORARI GRANTED DECEMBER 15, 1958

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1958

No. 512

CLIFTON E. BAIRD AND VIOLET L. BAIRD,
PETITIONERS,

vs.

COMMISSIONER OF INTERNAL REVENUE.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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[fol. A] [File endorsement omitted]

IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

No. 12230

CLIFTON E. BAIRD and VIOLET L. BAIRD, Husband and Wife, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Petition for Review of Decision of the Tax Court of the United States

Honorable Eugene Black, Judge

APPENDIX TO PETITIONERS' BRIEF—Filed February 28, 1958

[fol. 1]

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. .....

CLIFTON E. BAIRD and VIOLET L. BAIRD, (Husband and Wife), Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION—Filed November 7, 1955

The above named petitioners hereby petition for a redetermination of the income tax deficiencies aggregating $39,585.88 for the taxable years ended December 31, 1952 and December 31, 1953 set forth by the Commissioner of Internal Revenue in his notice of deficiencies (RC:Cin:Ap

Ind:FEH) dated August 11, 1955 and as a basis of their proceedings allege as follows:

1. The petitioners are individuals residing at Highway #56 West, Salem, Indiana. The tax returns for the years here involved were filed with the District Director of Internal Revenue for the District of Indiana.

2. The notice of deficiencies, a copy of which is attached hereto, and made a part hereof, and marked "Exhibit A" was mailed to the petitioners on August 11, 1955.

3. The tax deficiencies in controversy aggregating $39,585.88 were determined for the calendar years 1952 and 1953, such deficiency for the year 1952 being $16,499.72 and the deficiency for the year 1953 being $23,086.16.

4. The determination of tax deficiencies set forth in the notice of deficiencies is based upon the following errors:

(a) The Commissioner erred in the disallowance of de- [fol. 2] ductions in the amounts of $25,816.58 and $29,560.54 reported as cost of sales items in partnership returns of income filed by Baird Trailer Sales, a partnership, covering its fiscal years ended February 28, 1952 and February 28, 1953, it being in such partnership that the petitioners herein are partners.

(b) The Commissioner erred in the disallowance of a deduction in the amount of $6,955.88 reported as a loss from sale of property other than capital asset in the partnership return filed by the said Baird Trailer Sales covering its fiscal year ended February 28, 1953.

5. The facts upon which the petitioners rely as a basis of this proceeding are as follows:

(a) The petitioners are husband and wife and had been for some years prior to 1952.

(b) The petitioners' income tax returns are filed on a calendar year basis.

(c) The petitioners' income tax returns for the years 1952 and 1953 prepared on the cash basis were the joint returns of the petitioners.

(d) The petitioners during the years here in question were engaged as equal partners in the partnership known as the Baird Trailer Sales which partnership during the years of 1951, 1952 and 1953 had its principal office at Salem, Indiana. Baird Trailer Sales was organized on January 1, 1947, and it has been engaged since in the sale of new and used mobile homes commonly referred to as house trailers.

(e) In the sale of new and used house trailers, Baird Trailer Sales, in instances where the purchaser did not have sufficient property or funds to make payment therefor, was compelled for various business reasons to sell such trailer on a conditional sales contract arrangement.

(f) In instances where conditional sales contracts were [fol. 3] executed, it was the almost uniform practice of Baird Trailer Sales to sell such conditional sales contracts to such finance companies as were engaged in the practice of purchasing such contracts. A finance company frequently used by Baird Trailer Sales in the years here in question was the Minnehoma Financial Company, a Delaware Corporation, which has its principal office at 1900 North Sheridan Road, Tulsa, Oklahoma.

(g) In the sale of such conditional sales contracts to Minnehoma, and the arrangement with Minnehoma was typical of the arrangements made with other finance companies, Baird Trailer Sales regularly received 95 per cent of the retail cash sale price of the house trailer sold, such amount being increased by the extra equipment costs and taxes paid by the dealer, etc., and decreased by the amount of the down payment made by the purchaser either in cash and/or the trade-in allowances made on trailers taken in trade.

(h) Such sales of the conditional sales contracts to Minnehoma were made in accordance with a contract wherein it was provided that the 5 per cent retained portion would be used, to the extent that Minnehoma in its absolute discretion decided was satisfactory, to create or increase an account known as a dealer reserve account on the books of Minnehoma, there being such dealer reserve account for

each dealer from whom Minnehoma purchased conditional sales contracts.

(i) Upon the sale of such conditional sales contracts to Minnehoma or to others to whom such contracts were sold, it was the practice of Baird Trailer Sales to record on its books and records the full amount of the sale price as well as the amount which had been withheld by the trailer finance company, usually 5 per cent of the retail cash sale price as was noted above. Such retained amount was charged to an account entitled "Reserve on Financed [fol. 4] Trailers," the balance of such account at the end of the partnership year having been used as a cost of sales item in the determination of the partnership's gross profit.

(j) It was also provided in the contract entered into by and between Baird Trailer Sales and Minnehoma Financial Company that at such time or times as the said dealer reserve account held on Minnehoma's books for Baird Trailer Sales exceeded 15 per cent of the total aggregate unpaid balances of all contracts sold to Minnehoma and such other contingent liabilities as Minnehoma in its sole discretion decided, Minnehoma would pay such excess to Baird Trailer Sales at such time and in such amount as it chose. In consequence of such arrangement, payments or credits totaling $1,217.94 and $1,778.94 were received by Baird Trailer Sales in fiscal years ended February 28, 1952 and February 28, 1953 respectively and such amounts were credited to the account "Reserve on Financed Trailers" mentioned above.

(k) The contract entered into with Minnehoma provided that Baird Trailer Sales unconditionally guaranteed "the payment of all sums required to be paid under each contract purchased by and assigned to Minnehoma * * * when such payment shall become due." Baird Trailer Sales also guaranteed "full and faithful performance by the purchaser in any and all terms of the contract in addition to payment and agrees that at the election of Minnehoma, upon default by the purchaser in any of the terms and conditions of such agreement, the Dealer shall forthwith repurchase from Minnehoma such contract as to which the

purchaser shall have defaulted and shall pay to Minnehoma the entire amount unpaid under said contract."

(l) The contract entered into with Minnehoma also provided that "Minnehoma shall have the right to resell or reassign any contracts purchased from the Dealer, in [fol. 5] whole or in part, upon such terms and conditions as Minnehoma shall determine. No such assignment or sale shall constitute a waiver by Minnehoma of its rights under the assignment and sale from the Dealer to Minnehoma or its rights hereunder. Upon such resale or reassignment by Minnehoma, Minnehoma's assignees shall succeed to all of Minnehoma's rights under its assignment from the Dealer and all of its rights hereunder."

(m) In the preparation of the partnership return of income of Baird Trailer Sales covering its fiscal year ending February 28, 1952 a deduction was taken in computing cost of sales in the amount of $24,598.64, such amount being the total amount withheld, namely, $25,816.58, less the said payments or credits received in the amount of $1,217.94.

(n) In the preparation of the partnership return of income covering its fiscal year ending February 28, 1953, a deduction was taken in computing cost of sales in the amount of $27,781.61, such amount being the total amount withheld, namely, $29,560.55 less the payments or credits received in the amount of $1,778.94.

Wherefore, the petitioners respectfully pray that this Court may hear and determine their appeal.

The petitioners further pray that:

The Court may find that Baird Trailer Sales in its partnership returns of income filed with respect to its fiscal years ended February 28, 1952 and February 28, 1953 properly reported and determined its ordinary net income by inclusion of only those moneys or credits which were actually received in the sale of the conditional sales contracts.

The Court may find that the petitioners properly reported the correct partnership net income in their joint individual income tax returns filed for the calendar years 1952 and 1953.

[fol. 6] And the Court may grant to the petitioners such other and further relief as this Honorable Court shall find just and proper.

Lewis N. Angermeier, Adrian E. Wilhoite, 528 Chamber of Commerce Bldg., Indianapolis 4, Indiana, Counsel for Petitioners.

Duly sworn to by Clifton E. Baird and Violet L. Baird, jurat omitted in printing.

[fol. 7]

EXHIBIT A TO PETITION:

U. S. TREASURY DEPARTMENT
Internal Revenue Service
Regional Commissioner

Appellate Division, Cincinnati Region
8th Floor, Century Building
36 South Pennsylvania Street
Indianapolis, Indiana

Registered Mail

In Reply Refer to
RC:Cin:Ap:Ind:FEH
Aug. 11, 1955.

Mr. Clifton E. Baird and Mrs. Violet L. Baird
Highway #56 West
Salem, Indiana

Dear Mr. and Mrs. Baird:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1952 and December 31, 1953 discloses deficiencies in tax aggregating $39,585.88 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiencies mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for

a redetermination of the deficiencies. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday or legal holiday in the District of Columbia in which event that day is not counted as the [fol. 8] 90th day. Otherwise Saturdays, Sundays and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Assistant Regional Commissioner, Appellate Division, 8th Floor, Century Building, 36 South Pennsylvania Street, Indianapolis, Indiana. The signing and filing of this form will expedite the closing of your returns by permitting an early assessment of the deficiencies and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is earlier.

Very truly yours,

T. Coleman Andrews,
Commissioner,

By G. W. Snyder,
Associate Chief.

Enclosures:

Statement
Form 160
Agreement Form

Statement.

Clifton E. Baird and Violet L. Baird
(Husband and wife)

d/b/a Baird Trailer Sales,
Highway #56 West,
Salem, Indiana.

Income Tax Liability.

Taxable Year Ended	Deficiency Tax
12-31-1952	$16,499.72
12-31-1953	23,086.16
Total	$39,585.88

[fol. 9] In making this determination of your income tax liability, careful consideration has been given to the report of examination dated March 7, 1955, to your protest dated April 5, 1955, and to the statements made at the conference held on May 24, 1955.

If you do not acquiesce in all of the adjustments making up the deficiency indicated, but desire to stop the accumulation of interest on that part of the deficiency resulting from adjustments to which you agree, please fill out the enclosed form of waiver, inserting therein the amount of the deficiency you desire to have assessed at once. The execution of this form for the agreed portion of the deficiency will not deprive you of your right to petition The Tax Court of the United States for a redetermination of the deficiency.

A copy of this letter and statement has been mailed to your representatives, Messrs. Lewis Angermeier and Paul S. Stanley, 528 Chamber of Commerce Building, Indianapolis, Indiana, in accordance with the authority contained in the power of attorney executed by you.

Adjustments to Net Income,

Taxable year ended December 31, 1952.

Net income disclosed on return	$53,808.42
Plus: Additional income and unallowable deductions:	
(a) Partnership income	24,598.64
Total	$78,407.06
Less: Nontaxable income and additional deductions:	none
Net income adjusted	$78,407.06

[fol. 10] Explanation of Adjustments.

(a) It is determined that your share of the distributable income of Baird Trailer Sales partnership for the calendar year 1952 is $78,258.43. See Exhibit A.

Computation of Tax

Taxable year ended December 31, 1952.

Net income adjusted		$78,407.06
Less: Exemptions (8)		4,800.00
Balance subject to tax		$73,607.06
Less: Excess of net long-term capital gains over net short-term capital losses		296.96
Balance subject to tax at ordinary rates		$73,310.10
Joint return: ½ of $73,310.10	$36,655.05	
Normal tax: 3% of $36,655.05	$ 1,099.65	
Surtax: $15,056.00 plus 65% of $4,655.05	18,081.78	
Total	$19,181.43	
Joint return: $19,181.43 × 2		$38,362.86
Add. 52% of $296.96		154.42
Alternative tax		$38,517.28
Combined normal tax and surtax		$38,564.80
Income tax liability (lesser of $38,517.28 or $38,564.80)		$38,517.28
Self-employment tax (per return)		162.00
Total tax liability		$38,679.28
Less: Tax liability disclosed on return, Original list, Acct. No. AF 710883		22,179.56
Deficiency in income tax		$16,499.72

[fol. 11]

Adjustment to Net Income

Taxable year ended December 31, 1953.

Net income disclosed on return	$44,629.53
Plus: Additional income and unallowable deductions:	
(a) Partnership income	34,737.48
Total	$79,367.01

Less: Nontaxable income and additional deductions:	none
Net income adjusted	$79,367.01

Explanation of Adjustments.

(a) It is determined that your share of the distributable income of Baird Trailer Sales partnership for the calendar year 1953 is $79,257.61. See Exhibit A.

Computation Tax

Taxable year ended December 31, 1953.

Net income adjusted		$79,367.01
Less: Exemptions, (8)		4,800.00
Balance subject to tax		$74,567.01
Joint return: ½ of $74,567.01	$37,283.51	
Normal tax: 3% of $37,283.51	$ 1,118.51	
Surtax: $15,056.00 plus 65% of $5,283.51	18,490.28	
Total normal tax and surtax		$19,608.79
Joint return: $19,608.79 × 2		$39,217.58
Income tax liability		$39,217.58
Self-employment tax (per return)		162.00
Total tax liability		$39,379.58
Less: Tax liability disclosed on return, Original list Acct. No. AF 1001371		16,293.42
Deficiency in income tax		$23,086.16

[fol. 12] Exhibit A.

	2/29/52	2/28/53
Ordinary net income per partnership return	$53,659.79	$44,520.13
Add: Unallowable deduction and additional income:		

	2/29/52	2/28/53
1. Dealer "holdback" reserves	25,816.58	29,560.54
2. Capital loss deducted on dissolution of corporation		6,955.88
Total	$79,476.37	$81,036.55
Less: Nontaxable income and additional deductions:		
3. Dealer "holdback" reserves	1,217.94	1,778.94
Corrected partnership ordinary net income	$78,258.43	$79,257.61

Explanation of Partnership Adjustments:

1. Dealer "holdback" reserves have been included in the distributable net income of the partnership under the provisions of Section 22 of the 1939 Internal Revenue Code.

2. Capital loss on dissolution of corporation in which the partnership owned one-half of the stock was removed from the partnership ordinary net income under the provisions of Section 183(b) (2) (A) of the 1939 Internal Revenue Code.

3. Dealer "holdback" reserves were eliminated from partnership ordinary net income because under the theory of accrual basis of accounting these reserves should have been reported in the year of sale when the right to it became fixed under the provisions of Section 42 of the 1939 Internal Revenue Code.

[fol. 13]

Distribution:		Year 1952		Year 1953	
Partner's name	Profit & Loss Ratio	Ordinary Net income	Capital Gain	Ordinary Net income	Capital Gain
Clifton E. Baird	50%	$39,129.22	$296.96	$39,628.81	($4,122.42)
Violet L. Baird	50%	39,129.21	296.95	39,628.80	($4,122.42)
		$78,258.43	$593.91	$79,257.61	($8,244.84)
Corrected partnership net income		$78,258.43		$79,257.61	
Partnership net income reported on return		53,659.79		44,520.13	
Adjustment		$24,598.64		$34,737.48	

BEFORE THE TAX COURT OF THE UNITED STATES

* * (Caption—60132) * *

ANSWER—Filed December 15, 1955

Comes now the Commissioner of Internal Revenue, by his attorney, John Potts Barnes, Chief Counsel, Internal Revenue Service, and for answer to the petition filed by the above named petitioners, admits and denies as follows:

1, 2, and 3. Admits the allegations of paragraphs 1, 2, and 3, of the petition.

4(a) and (b). Denies that the Commissioner erred as alleged in subparagraphs (a) and (b) of paragraph 4 of the petition.

5(a) and (b). Admits the allegations of fact in subparagraphs (a) and (b) of paragraph 5 of the petition.

5(c). Admits that petitioners filed joint income tax returns for the taxable years 1952 and 1953. Denies the remaining allegations of fact contained in subparagraph (c) of paragraph 5 of the petition.

5(d). Admits that petitioners, during the years here in question, were engaged in the partnership known as the Baird Trailer Sales, which partnership, during the years [fol. 14] 1951, 1952 and 1953, had its principal office at Salem, Indiana, and has been engaged in the sale of new and used mobile homes commonly referred to as house trailers. Denies the remaining allegations of fact contained in subparagraph (d) of paragraph 5 of the petition.

5(e) to (n), inclusive. Denies the allegations of fact contained in subparagraphs (e) to (n) of paragraph 5 of the petition.

Denies generally each and every allegation contained in the petition not hereinbefore expressly admitted, qualified or denied.

Wherefore, it is prayed that the petitioners' appeal be denied, and that the Commissioner's determination be approved in all respects.

John Potts Barnes, Chief Counsel, Internal Revenue Service.

Of Counsel: Clarence E. Price, Regional Counsel, Gene W. Reardon, Asst. Regional Counsel, John L. Carey, Special Attorney, Internal Revenue Service, 504 Insurance Building, Indianapolis 4, Indiana.

[fol. 15]

BEFORE THE TAX COURT OF THE UNITED STATES

Docket Nos. 60132 and 63907

CLIFTON E. BAIRD and VIOLET L. BAIRD, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

STIPULATION OF FACTS—Filed April 29, 1957

It Is Hereby stipulated that the following facts may be received in evidence in these cases without further proof, subject to the right of either party to object to the irrelevancy or immateriality thereof and reserving to each party the right to offer any additional evidence not inconsistent herewith:

1. The petitioners, Clifton E. Baird and Violet L. Baird, are husband and wife, who now reside, and who resided during the taxable years involved, in Salem, Indiana. They signed and filed joint individual income tax returns for the taxable years ended December 31, 1952, 1953 and 1954, inclusive, with the District Director of Internal Revenue for the District of Indiana, Indianapolis, Indiana. True and correct copies of such returns are attached hereto as Exhibits 1-A to 3-C, respectively.

2. The petitioners are equal partners in a partnership doing business as Baird Trailer Sales (hereinafter referred to as "the partnership"). The partnership has its principal office and place of business at Salem, Indiana, and was organized on or about January 1, 1947. It has engaged since that time in the sale of new and used mobile homes, usually referred to as house trailers, and in the sale, to a lesser extent of new and used cars, parts and accessories,

[fol. 16] furniture, and real estate. Partnership returns of income filed by Baird Trailer Sales for the fiscal years ended February 28, 1952, February 28, 1953 and February 28, 1954, and an amended partnership return of income for the fiscal year ended February 28, 1952, were signed by Clifton E. Baird, as partner, and filed with the District Director of Internal Revenue for the District of Indiana, Indianapolis, Indiana. True and correct copies of such returns are attached hereto as Exhibits 4-D to 7-G, respectively.

3. From the date of its organization throughout the years here involved, the partnership maintained its books and records, on the accrual method of accounting, and on a fiscal year ending February 28. The partnership deducted bad debts under the specific bad debt charge-off method. Petitioners filed their joint individual returns on the cash basis and used the calendar year.

4. For the fiscal years ended February 28, 1952, 1953 and 1954, the partnership books and records reflected gross sales in the respective amounts of $1,025,943.89, $1,337,385.64 and $1,067,144.18. The cost of sales for such fiscal years were reflected on the partnership books and records as follows:

	FY Ended 2/28/52	FY Ended 2/28/53	FY Ended 2/28/54
Overallowance on Trailers and Furniture	$ 31,276.19	$ 39,102.87	$ 69,811.55
Reserve on Financed Trailers	24,598.64	27,781.61	20,519.18
Trailer Reconditioning	646.58	1,518.52	2,171.10
Cost of New Cars	25,222.08	—	—
Cost of Used Cars	63,939.64	26,685.04	14,380.45
Cost of Parts and Accessories	8,416.69	3,936.50	7,947.25
Cost of Gas, Oil, etc.	—	210.96	135.79
Cost of Trailers (New)	673,247.38*	679,499.81	457,747.42
Cost of Trailers (Used)	—	287,666.02	293,068.44
Cost of Miscellaneous	2,153.91	2,220.60	581.69
Cost of Real Estate	—	4,960.23	1,017.50
Cost of Furniture	30,245.64	67,726.43	41,147.50
Discount Earned	—	—	(500.00)
Cost of Sales Reported in Returns	$859,746.75	$1,141,308.59	$908,027.87

* Includes cost of new and used trailers.

[fol. 17] 5. During such years the partnership sold most of its trailers under conditional sales contracts to only three finance companies, namely: Minnehoma Financial Company, Tulsa, Oklahoma; Michigan National Bank, Grand Rapids, Michigan, and Midland Trailer Finance Corporation, Cincinnati, Ohio. Midland Trailer Finance Corporation is the successor to business organizations known as "Midland Discount Company" and "Midland Trailer Finance Company"; reference to any of such business designations shall be taken and understood to be a reference to the same business entity. (Such companies will hereinafter be specifically referred to as "Minnehoma", "Michigan" and "Midland", respectively, and collectively referred to as "the finance company" or "the finance companies.") In such cases, the purchaser executed a note payable to the partnership for the unpaid purchase price of the trailer, plus insurance, interest and financing charges, and gave a chattel mortgage on the trailer as security for payment of the note. In the case of Minnehoma the contract took the place of the note payable. Attached hereto as Exhibits 8-H, 9-I and 10-J are sample copies of such conditional sales contracts and notes prescribed by Minnehoma, Michigan and Midland, respectively.

6. Most of the notes accepted by the partnership in part payment for trailers were sold to one of the three above-named companies in accordance with the terms and agreements between the partnership and each such company. There is attached hereto, as Exhibit 11-K, a true and correct copy of an agreement between the partnership and Minnehoma dated December 30, 1949. A true and correct copy of the agreement between the partnership and Minnehoma dated November 8, 1950, is attached hereto as Exhibit 12-L, together with a modification notice dated December 21, 1950, a true and correct copy of which is attached as Exhibit 13-M.

[fol. 18] 7. The written portion of the agreement between the partnership and Michigan is embodied in a "Collateral Assignment", a true and correct copy of which is attached hereto as Exhibit 14-N.

8. The written portion of the original agreement between the partnership and Midland is embodied in two letters, dated December 3, 1951, and December 18, 1951, true and correct copies are attached hereto as Exhibits 15-O and 16-P. On or about December 12, 1951, the partnership transmitted to Midland Trailer Finance Corporation a balance sheet and other information, a true and correct copy of which communication is attached hereto as Exhibit 17-Q. From December 18, 1951, to June 10, 1952, the partnership sold notes to Midland under the terms of the letter dated December 18, 1951. On and after June 10, 1952, the notes were sold under the terms of a letter from Midland dated June 4, 1952, a true and correct copy of which is attached hereto as Exhibit 18-R. Attached hereto as Exhibit 19-S is a true and correct copy of a letter from Midland to the partnership dated December 12, 1952.

9. Under the terms of its agreements with the three finance companies, the partnership sold most of its trailer notes to the finance companies for the deferred purchase price of the trailers plus in certain cases a percentage of the interest or finance charges. As each note was transferred to it with recourse, the finance company remitted to the partnership the amount due it on the selling price of the trailer as above-described, less an amount which was credited on its books to an account in the name of the partnership designated "Dealer Reserve Account" by Minnehoma and Midland and designated "Dealer Escrow Account" by Michigan. Hereinafter, the use of the phrase "Dealer Reserve Account" includes the phrase "Dealer Escrow Account." The amount withheld and credited to such account was usually 5 percent of the unpaid balance [fol. 19] on each note, or with some finance companies on a new trailer only 3 percent of the unpaid balance on the note. Further, in certain instances, Minnehoma and Midland also credited to the partnership's account a portion of the finance charge. At the time of sale, the finance companies sent the partnership a memorandum of the amount thus withheld and credited. The partnership also received periodic statements of the balances in the accounts designated "dealer's reserve" or "dealer's escrow account" from the finance companies.

10. On the sale of a note, the partnership always endorsed the note to the finance company either with recourse and/or with their guaranty of the unpaid balance of the note.

11. The partnership was not required by the finance companies to do business with one finance company to the exclusion of other companies who dealt in considerable paper of the nature of that purchased from the partnership. Prior to February 28, 1951, the partnership had sold notes to other companies, including Union Bank of Michigan, Pioneer Finance Company, Kent Bank and Evansville Morris Plan.

12. The agreements with the three finance companies either oral or written contained the following provisions:

(a) In the event the retail purchaser's contract became due and unpaid, the finance company could charge the account of the partnership designated "Dealer Reserve" with the unpaid balance;

(b) In the event the partnership had a matured financial obligation of any nature to the finance companies, the amount of such obligation could be charged to the partnership's account designated "Dealer Reserve";

(c) Repossession losses of the finance companies could be charged to the account of the partnership of designated "Dealer Reserve";

[fol. 20] (d) The ultimate balance in the account of the partnership designated "Dealer Reserve" after payment of all notes by the partnership to the finance companies was to be paid to the partnership; and

(e) Each finance company could look to the balance in the account designated "Dealer Reserve" of the partnership to satisfy any default by the partnership on its guaranties and obligations to the finance company, as well as any default by the makers of the notes.

13. The accounts on the finance company's books designated "dealer reserve" for the partnership were reflected as a liability of the finance company and the annual balances in such accounts were not reflected in the income of the finance company.

14. A typical trailer sales transaction is illustrated as follows:

Sales Price of Trailer	$5,545.00
Cash Down Payment (and/or Trade-in Allowance)	1,745.00
Balance Due Baird Trailer Sales	$3,800.00
VSI (Skip Insurance), Credit Check, Insurance	$ 420.00
Principal (Amount of Note)	$4,220.00
Financing Charges paid to Finance Company	1,265.80
Balance due Baird Trailer Sales	$3,800.00
Credited to reserve of Baird Trailer Sales	190.00
Cash Paid Baird Trailer Sales by Finance Co.	$3,610.00

15. During the years here involved, the partnership (by way of illustration) recorded the sale of a trailer and the sale of the note on its books and records as follows:

[fol. 21] *Sales Receipt Journal Entry.*

Cash and/or Trade-in Allowance	$1,745.00	
Contracts Receivable — Finance Company	3,800.00	
Trailer Sales		$5,545.00

When the Finance Company remitted the check, the following entry was made:

Reserve—Finance Company	$ 190.00	
Cash	3,632.67	
Expense for Intangible Stamps	1.38	
Contracts Receivable		$3,800.00
Expenses (Credit Check)		24.05
Cost of Sales		$3,824.05
Cost of Sales	$3,824.05	
Credit Inventory		$3,824.05

16. From the date of organization throughout the years involved, the partnership was at no time delinquent in any payments due the finance companies and most of the trailer purchasers were paying their notes when due.

17. On its returns for the taxable years 1952, 1953 and 1954, the partnership deducted specific bad debts in the respective amounts of $1,203.75, $2,239.12 and $1,203.69. True and correct copies of the bad debt schedule for such years are attached at Exhibits 20-T, 21-U and 22-V. A portion of such deductions were unpaid amounts due the partnership for accessories, supplies and repairs. The remainder consisted of advances by the partnership to meet the trailer purchaser's payments due a finance company under trailer conditional sales agreement which the purchaser was unable to make and after advancement a default by the purchaser occurred.

18. When a purchaser defaulted on his contract and note, the trailer was repossessed upon receipt of notice of default. The partnership always paid the finance com- [fol. 22] pany the unpaid balance due on such note and recorded such payment on its books and tax returns as a purchase. Where defaults occurred on the notes payable to the partnership, the payment paid to the finance companies as a result of the defaults were included on the partnership's fiscal year 1952, 1953, and 1954 returns as part of costs of goods sold. On resale of the repossessed trailer, the receipts therefrom were reported as gross receipts. For example, if a trailer costing $5,545.00 with notes payable outstanding of $3,500.00 was repossessed and the trailer's fair market value was only $3,000.00, the loss, if any, was reflected on the partnership's books and records as part of cost of goods as follows: The bookkeeper of the partnership either on the date of repossession or at the close of the fiscal year charged $500.00 to overallowance on trailers and recorded the purchase price of the trailer in cost of used trailers at $3,000.00 (its fair market value). However, if the trailer was sold during the fiscal year in which it was repossessed, and the bookkeeper had not charged $500.00 to overallowance on trailers, the purchase price of the trailer was reflected in cost of used trailers

at $3,500.00, and the sales price of $3,000.00 reported in gross receipts. In the event the notes payable outstanding were $3,000.00 or less in the above example, the purchase price of the trailer was reflected in cost of used trailers at the amount paid by the partnership on the unpaid balance of the note payable. The finance company remitted to the partnership the amount which had been credited to the account designated "Dealer Reserve" with respect to such defaulted contract and note and the partnership reported such amount in taxable income for the year of receipt, except for the years 1948 and 1949 which were reported as set forth in paragraph 23. Upon sale of such repossessed trailer to another purchaser, the transaction was handled [fol. 23] exactly as with respect to the original sale of the trailer. No delinquent notes were charged to the partnership's accounts designated "Dealer Reserve" by any finance company during the taxable years 1952, 1953 and 1954.

19. During the years here involved, the finance companies were in such good financial condition that they were able to pay any accounts which might have been due and payable to the partnership out of the Dealer Reserve.

20. As of February 28, 1952, 1953 and 1954, the accumulated balances in the accounts designated below and the amount unpaid on notes signed by the purchasers of the trailer and sold with recourse to the several finance companies were as follows:

Minnehoma Financial Company:

	"Dealer Reserve Account"	Unpaid Balance
February 28, 1952	$16,311.73	$224,677.16
February 28, 1953	21,279.30	207,346.78
February 28, 1954	25,438.69	185,398.65

Michigan National Bank.

	"Dealer Escrow Account"	Unpaid Balance
February 28, 1952	$20,187.55	Unavailable
February 28, 1953	18,993.01	$ 94,930.14
February 28, 1954	19,218.03	92,577.49

Midland Trailer Finance Corporation.

	"Dealer Reserve Account"	Unpaid Balance
February 28, 1952	$ 3,572.39	$ 93,043.00
February 28, 1953	28,347.95	*650,000.00
February 28, 1954	39,065.43	760,879.00

[fol. 24] 21. During the fiscal years February 28, 1952, 1953 and 1954, Minnehoma Financial Company, Michigan National Bank and Midland Trailer Finance Corporation credited the following total amounts to the account of the partnership designated "Dealer's Reserve" on the books of such companies:

1952	$25,816.58
1953	29,560.54
1954	29,660.49

22. During the fiscal years 1952, 1953 and 1954, the partnership received the respective amounts of $1,217.94, $1,778.94 and $9,141.39 from the finance companies out of its accounts designated "Dealer Reserve" on the books of the finance companies including Union Bank of Michigan, Pioneer Finance Company, Kent Bank and Evansville Morris Plan. Attached hereto as Exhibits 23-W, 24-X and 25-Y are transcripts of the ledger account of the partnership designated "Dealer Reserve" for the respective taxable periods showing debits and credits to the reserve account on financed trailers.

23. In its partnership returns for the taxable years ended February 28, 1949, and February 28, 1949, (sic) the credits to the accounts designated "Dealer Reserves" were included in taxable income.

24. The testimony received in the Tax Court Case of Blaine and Evelyn K. Johnson, Docket No. 52306 on September 23 and 24, 1954, where material and relevant to the instant petitioners may be considered as if given in the

* This figure is an approximation furnished by the corporation in letter dated April 18, 1957, since it made no analysis of unpaid notes as of February 28, 1953.

instant case. For convenience, attached hereto as Exhibit 26 Z are portions of the testimony from the Johnson transcript.

25. In computing the gross receipts reported in its returns for the fiscal years February 28, 1952 to 1954, inclusive, the partnership deducted the total amount credited by the finance companies in each year to the partnership's [fol. 25] account designated "dealer's reserve" from its gross sales per books and records to arrive at the amount reported as gross receipts on its income tax returns. In determining the net income of the partnership, the respondent included such amounts in taxable income. In determining the deficiencies herein, the respondent reduced the aforesaid amounts of $25,816.58, $29,560.54 and $29,660.49 described in Paragraph 21 by the aforesaid amounts of $1,217.94, $1,788.94 and $9,141.31 and added the net amounts of $24,598.64, $27,781.61 and $20,519.18 to taxable income of the partnership for the taxable years 1952, 1953 and 1954, respectively.

Lester M. Ponder, 1313 Merchants Bank Building, Indianapolis 4, Indiana, William L. Thompson, Farmers Bank Building, Salem, Indiana, Counsels for Petitioners.

Nelson P. Rose, Chief Counsel, Internal Revenue Service, Counsel for Respondent.

[fol. 26]

BEFORE THE TAX COURT OF THE UNITED STATES

Transcript of Testimony in Docket Nos. 60132 and 63907 (Excerpts)

Testimony of Clifton E. Baird:

"Q. Mr. Baird, will you state to the Court who prepared the various written agreements that you have testified about, with these finance companies?

"A. They were prepared by the companies, mailed to us for our signature, to be returned to the companies.

"Q. Did you make any suggestion which was embodied in the form of the written contract, which you have testified about?

"A. No, sir. Those were the standard terms of the contracts available to my company.

"Q. Was any term—strike that. Will you state whether any term in those contracts was prescribed by you?

"A. No, sir. None whatsoever.

"Q. Will you specifically state to the Court whether you prescribed the provisions in the contract pertaining to a holding back of any amount and placing a credit in an account, designated 'dealer reserve'?

"A. I did not.

"Q. State to the Court whether you ever suggested that any amounts be held back from amounts under contracts sold to you by the finance companies?

"A. No, sir, I didn't.

"Q. State to the Court why you sold any notes and contracts to the finance companies, instead of retaining those notes and contracts in your own possession?

"A. We were not financially able to carry the contracts, that originated with our company. We didn't have the money for that size of operation.

[fol. 27] "Q. State to the Court what needs you had for any money during that period, in your business?

"A. State that question again, please?

"Q. State to the Court what were the needs of your business, for cash, during the taxable period. For what uses.

"A. Well, we needed cash for operating capital, to replenish our inventories, normal expenses in conducting the business.

"Q. State to the Court whether the amounts that you received from the finance companies, on the sale of your notes and contracts, was then used for such purposes as you have described in your business?

"A. Yes, sir.

"Q. State to the Court whether you ever requested a finance company to retain any amounts that were then due you, under the contracts, in payment?

"A. No, sir, I never did.

"Q. Now I show you Exhibit 4-D—strike it—Exhibit 4-D. I show you Exhibits 4-D, 5-E and 6-F, and also 7-G, which are respectively the partnership income tax returns for

Baird Trailer Sales for the fiscal years 1952, 1953, 1954, and Exhibit 7-G is an amended partnership return for the year '52. I turn your attention on each of those returns; I turn your attention to Page 3, I'm now showing you Exhibit 7-G which is the amended partnership return for fiscal 1952, turn your attention to page 3, and to question 5, at the bottom of Page 3, reading as follows: 'Check whether this return was prepared on the cash or accrual basis' and I ask you to state to the Court what the answer is shown as shown on that return?

"A. The X indicates the accrual basis. As an equal partnership, Baird Trailer Sales, with the partnership returns for the years '52-3 and 4, filed, prepared and filed on an accrual basis.

[fol. 28] "Q. Were you active in the operation and management of the partnership of Baird Trailer Sales throughout this taxable period.

"A. Yes, sir.

"Q. In that capacity, were you familiar with the financial records and statements which were prepared for that partnership?

"A. Yes, sir.

"Q. State whether you would review such statements and records as a part of your regular business duties?

"A. Yes, sir.

"Q. State whether during the taxable period it was necessary for Baird Trailer Sales to submit balance sheets showing its assets and liabilities, to banks and credit organizations such as Dun & Bradstreet, in order to show the financial condition of the partnership?

"A. Yes, sir.

"Q. State whether as a practice of your partnership business, in submitting such balance sheets to the described organizations, the balances that had been credited on the books of the finance companies, to the accounts designated 'dealer reserve' were reflected as assets on those balance sheets?

"A. They were not." (Tr. pp. 12-16.)

* * * * * * *

"Q. Now, Mr. Baird, I call your attention to Paragraph 20 of the stipulation of facts, and I show you the stipulation

of facts, calling to your attention particularly the contents of Paragraph 20, in Paragraph 20, the statement is made that as of February 28th, 1952, 1953, and 1954, the accumulated balances in the accounts designated below, and the amount unpaid on notes signed by the purchasers of the trailer, and sold with recourse to the several finance companies, were as follows. Then, is set forth a tabulation of [fol. 29] three companies, which have already been stipulated as the companies with which you did business.

"Now will you state to the Court the source of the figures that are set forth in that tabulation, in Paragraph 20?

"A. These figures are the ones supplied to us by the three companies with which we were doing business, and which had held dealers' reserves, on unpaid balances of contracts we had sent in." (Tr. pp. 17-18.)

Testimony of Joseph Hayden:

"The Clerk: Could we have your name?

"Mr. Hayden: Joseph Hayden, H-a-y-d-e-n.

"The Clerk: Thank you.

"By Mr. Ponder:

"Q. Will you state your address, your business address?

"A. 1108 First National Bank Building.

"Q. What city?

"A. Cincinnati, Ohio.

"Q. Will you state your present occupation?

"A. I'm Vice President of Midland Trailer Finance Corporation.

"Q. How long have you been associated with that company, approximately?

"A. Since 1951. December '51, or January '52.

"Q. In your capacity as Vice President, could you describe to the Court generally the nature and scope of your duties?

"A. Well, in reality, I manage that Trailer office, take care of the general office procedure of it, I'm in charge of dealer control accounts and dealer solicitation, new business solicitation.

"Q. In that capacity of soliciting new business and contacting trailer dealers, have you ever had occasion to contact Mr. Clifton E. Baird of Salem, Indiana?

[fol. 30] "A. Yes, many times.

"Q. Can you recall about when you began to do business personally, that is, with Mr. Baird?

"A. You mean when I first personally met him, or when I first—

"Q. Yes, when you first personally met him, in a business way.

"A. That was in March or April of 1952.

"Q. Since that time have you had occasion to deal with him from time to time in your business activities?

"A. Constantly.

"Q. Could you state whether you are the responsible person in your company to deal with Mr. Baird in his financing of trailers, in so far as your company is concerned?

"A. Yes, I am.

"Q. Now, Mr. Hayden, in your absence there has been a great deal of reference to a stipulation of facts, together with exhibits which have been introduced in evidence in this case.

"In that stipulation of facts there is repeated reference to letters dated December 3rd, December 18th, 1951, that's 3rd, and December 18, 1951, and June 4th, 1952, which are respectively Exhibits 15-O, 16-P, and 18-R, to the stipulation of facts.

"I hand you these documents so identified and ask you to look at them carefully before I ask you a question.

"(Witness examining documents.)

"By Mr. Ponder:

"Q. Now, calling your attention to Exhibit 16-P, which is a letter dated December 18, 1951, and particularly to the third paragraph thereof, I read you the language stating that 'The differentials of three per cent and five per cent will accumulate to provide you with a loss reserve. [fol. 31] When this reserve fund exceeds ten per cent of your outstandings, the excess will be paid to you, automatically.'

"Now, will you state to the Court whether the provision which I have just read, was inserted in that letter at the instance of Midland Discount Company or at the instance of Mr. Baird?

"A. At our instance.

"Q. Will you state to the Court, why your Company inserted such a provision?

" * * *

"A. The reason that we set it up was to protect the finance company against possible loss.

"By Mr. Ponder:

"Q. Now, when you say 'possible loss' to what do you refer at that point?

"A. Well, we buy this paper from all of our dealers on a straight endorsed basis, in other words, it's fully recoursed. If a trailer is given to a note-maker and the note-maker can't pay for it, the dealer has to take it back, if he can't pay us off, then, the net pay-off on the trailer, we would take the reserve money to liquidate the account."

(Tr. pp. 37-41.)

BEFORE THE TAX COURT OF THE UNITED STATES

EXHIBIT 12-L.

Agreement Covering Purchase of Conditional Sales and Other Time Sales Contracts.

Agreement, made and entered into in Tulsa, Oklahoma, by and between Baird Trailer Sales of Highway No. 56, Salem, Indiana, a Spartan Aircraft Trailercoach Dealer, hereinafter referred to as "Dealer" and Minnehoma Financial Company, a Delaware corporation, of Tulsa, Oklahoma, hereinafter referred to as "Minnehoma"

[fol. 32] Witnesseth:

Whereas, the Dealer is engaged in the business of selling Spartan Aircraft Trailercoaches, and from time to time

sells such trailercoaches under conditional sales contracts, notes, and chattel mortgages, or other instruments evidencing time sales, hereinafter referred to as "contracts", and the Dealer may desire Minnehoma from time to time to purchase in Tulsa, Oklahoma, and acquire by assignment, certain of such contracts and all rights thereunder, and Minnehoma may from time to time be willing so to do; and

Whereas, the parties hereto desire to set forth the terms and conditions which shall cover any such purchase and acquisition of contracts by Minnehoma;

Now, Therefore, in consideration of the sum of One Dollar ($1.00), each to the other paid, the receipt of which is hereby acknowledged, and of the mutual terms, conditions and covenants herein contained, it is agreed as follows:

1. The Dealer shall not be obligated to sell any contracts to Minnehoma, but may offer Minnehoma such contracts as the Dealer may from time to time choose, and Minnehoma shall not be obligated to purchase or acquire any contracts offered for sale and assignment by the Dealer, but shall purchase only such contracts as it is willing to do. This agreement shall govern only the sale and assignment of such contracts as the Dealer shall elect to sell and Minnehoma shall indicate its willingness to purchase and acquire.

2. The Dealer warrants, represents, agrees, and undertakes, as to each and every contract offered for sale and assignment to Minnehoma, and the sale of the trailercoach(es) covered thereby, as follows:

(a) That the sale will cover only a new or used trailercoach manufactured by Spartan Aircraft Company.

[fol. 33] (b) That the purchaser of such Spartan Aircraft Trailercoach shall have paid in cash and/or by trade-in of another trailercoach at no more than the blue book retail price, therefore ("the blue book" being defined as the current issue, as of the time of trade-in, of the Official Trailer Coach Guide published by the

Recording & Statistical Corp., New York City, N. Y.) a portion to be designated from time to time by Minnehoma by notice to the Dealer, of the gross sales price, including all extras, insurance, filing fees, sales taxes and other taxes and fees and charges with relation thereto, other than the time price differential hereinafter referred to.

(c) That as to each contract offered for sale and assignment by the Dealer, the Dealer has good title to the contract and full right to assign the same together with the deferred balance therein described; that the purchaser under said contract has signed only one contract with respect to the Spartan Aircraft Trailercoach covered thereby and that such contract is the one assigned by the Dealer; that the Spartan Aircraft Trailercoach has been delivered to the purchaser in good order and accepted by the purchaser; that the entire deferred balance is unpaid and due on the respective dates set forth in the contract; that the Dealer has made no previous assignment or sale of the contract offered for sale and assignment to Minnehoma or of any installment to be paid under the contract; that the purchaser under the contract has no set-offs, counter-claims, or defenses as to the collection of the sum to be paid under the contract or any part thereof.

(d) That the Dealer shall obtain from the purchaser and forward to Minnehoma one copy of a form furnished by Minnehoma and properly filled in and executed by the purchaser making certain representations for the purpose of securing credit for the purchase of the trailercoach covered by the contract, and shall also obtain and forward to Minnehoma a Dun & Bradstreet's or Retail Merchants' report in duplicate as to such purchaser.

3. Each contract offered to Minnehoma for purchase shall [fol. 34] be on the form specified by Minnehoma and shall be duly executed by the purchaser and the Dealer with the blanks properly filled in and the assignment shall be duly executed by the Dealer with the blanks properly filled in

and all filing requirements and other requirements of applicable law shall have been complied with.

4. Each contract shall require the purchaser to pay the total cash sales prices, plus the following:

(a) Sales and other taxes payable and the price of extra equipment and other extras;

(b) All applicable filing and recording fees;

(c) If satisfactory insurance is not furnished by the purchaser covering Minnehoma, the amount payable by Minnehoma for Fire, Theft, Combined Additional Coverages, Collision and V. S. I. and Embezzlement insurance premiums;

(d) The finance or time payment charge which shall be computed on the basis of 5% on new trailers and 6% on used trailers per year or such other rate as may be set by Minnehoma from time to time, of the aggregate of the foregoing less the down payment made to the Dealer in cash or by trade-in allowance, for the time elapsing between the date of the contract and the date when the final installment shall become due;

and less the down payment made to the Dealer in cash or by trade-in allowance.

The entire amount payable by the purchaser shall be payable in equal monthly installments over a period of not more than sixty (60) months for new trailers and thirty-six (36) to sixty (60) months, depending on the model, for used trailers, or such other durations as may be specified by Minnehoma from time to time, at the office of Minnehoma in Tulsa, Oklahoma. In the event that the purchaser makes payment of such installments to the Dealer, the Dealer shall receive such payments in trust, as the agent of the purchaser, and as such agent shall [fol. 35] forward the payments immediately to Minnehoma at Tulsa, Oklahoma, and payments of such installments shall not be deemed to have been made until received by Minnehoma.

5. As to all contracts which the Dealer desires Minnehoma to purchase after the same shall have been executed by the purchaser in accordance with its terms and in accordance with this agreement, the Dealer shall offer the same to Minnehoma at its office in Tulsa, Oklahoma, for purchase either by causing it to be delivered at such office or by mailing such contract duly executed together with the assignment duly executed by the Dealer and proper evidence of recording required by state laws. Within a period of fifteen (15) days Minnehoma shall either (1) notify the Dealer of its unwillingness to purchase the said contract, or (2) notify the Dealer of its acceptance of the contract and forward to the Dealer the purchase price thereof, as provided herein.

6. The purchase price of each contract purchased by and assigned to Minnehoma hereunder shall be equal to 95% of the aggregate of the retail cash sales price of the trailercoach and all extra equipment and all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance.

7. An amount to be determined by Minnehoma from time to time in its absolute discretion equal to not more than 5% of the aggregate of the retail cash sales price of the trailercoach and all extra equipment and all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance will be credited by Minnehoma to a special reserve account in the name of the Dealer hereunder as to each contract purchased by and assigned to Minne- [fol. 36] homa hereunder, which account will be referred to as the "Dealer Reserve Account". In addition, Minnehoma may credit to such Dealer Reserve Account hereunder, but shall not be obligated so to do, one-fifth (1/5) on new trailers and one-sixth (1/6) on used trailers, or such other portions as Minnehoma may determine from time to time, of the finance charge paid or agreed to be paid by the purchaser in each contract. In addition to and without affecting any

or all of its rights hereunder, Minnehoma may, at its own option, charge against the Dealer Reserve Account any sums that the Dealer may at any time owe to Minnehoma in any connection whatsoever. In the event and at such time or times as the Dealer Reserve Account shall exceed 15% of the aggregate unpaid balances of all contracts purchased by and assigned to Minnehoma hereunder by the Dealer plus all contingent liabilities which, on the sole determination of Minnehoma, it may have with respect to such contracts, Minnehoma will pay such excess to the Dealers from time to time as determined by Minnehoma but not more frequently than once each month. In the event that and at such time as all contracts as shall have been purchased and assigned to Minnehoma by the Dealer shall have been paid in full and no sums shall remain unpaid thereunder and in the opinion of Minnehoma there shall be no contingent liability on the part of Minnehoma with relation thereto, Minnehoma shall pay to the Dealer the balance of the credit in such Dealer Reserve Account. Minnehoma's determination as to the possibility of contingent liability shall be final and not subject to question by the Dealer.

8. The Dealer unconditionally guarantees the payment of all sums required to be paid under each contract purchased by and assigned to Minnehoma hereunder when such payment shall become due. In the event that the purchaser defaults or fails to pay any installment due under any contract purchased by and assigned to Minnehoma [fol. 37] hereunder, the Dealer agrees on demand of Minnehoma to pay such sum then due or, upon request of Minnehoma, to repurchase the contract from Minnehoma for the amount of the entire balance remaining unpaid. Anything herein to the contrary notwithstanding, the Dealer may at its election at any time repurchase from Minnehoma any contract theretofore sold and assigned to Minnehoma upon payment of the entire balance remaining unpaid under said contract. In the event of such repurchase and the payment of the repurchase price by the Dealer, Minnehoma shall assign to the Dealer any and all rights it may have in and to such contract. The Dealer also guarantees full and faithful performance by the purchaser in any and

all terms of the contract in addition to payment, and agrees that at the election of Minnehoma, upon default by the purchaser in any of the terms and conditions of such agreement, the Dealer will forthwith repurchase from Minnehoma such contract as to which the purchaser shall have defaulted and shall pay to Minnehoma the entire amount unpaid under said contract.

9. The failure by Minnehoma to take advantage of any default when the same shall have occurred shall not constitute a waiver by Minnehoma of such default and shall not prevent Minnehoma from enforcing the Dealer's guaranty or requiring the Dealer to repurchase the contract so long as the said default shall still be in force or as to any subsequent default.

10. At the election of Minnehoma and at its request, the Dealer will, at the Dealer's expense and at the Dealer's risk, proceed to repossess for the account of Minnehoma lawfully and in accordance with the laws of the State applicable, any trailercoach concerning which there is a default under the contract. Neither the making of such request, the initiation of proceedings to repossess the trailercoach or the actual repossession of the trailercoach shall consti- [fol. 38] tute a waiver by Minnehoma of the Dealer's guaranty of the purchaser's performance under the contract, nor the obligation of the dealer to repurchase contract as hereinabove set forth, but at any time prior to full payment to Minnehoma of the sums due under the contract, Minnehoma may require the dealer, as to all contracts in default, to repurchase the same as hereinabove set forth. As to all trailercoaches which shall have been repossessed, the Dealer agrees to purchase the same from Minnehoma and to pay Minnehoma therefor the full amount unpaid under the contract plus any expenses which Minnehoma may have had in connection with the repossession.

11. The Dealer agrees fully to observe and comply with the laws of the United States or any state or political subdivision thereof or territory or other jurisdiction applicable to the sale of the trailercoach covered by the contract, the execution and delivery of the contract, necessary to

make the contract valid and enforceable, essential for the effective assignment and sale of the contract and where applicable the repossession of the trailercoach. The Dealer agrees to indemnify Minnehoma from and against all penalties or liability on the part of Minnehoma under any such law by reason of the noncompliance therewith.

12. Minnehoma shall have the right to resell or reassign any contracts purchased from the Dealer, in whole or in part, upon such terms and conditions as Minnehoma shall determine. No such assignment or sale shall constitute a waiver by Minnehoma of its rights under the assignment and sale from the Dealer to Minnehoma or its rights hereunder. Upon such resale or reassignment by Minnehoma, Minnehoma's assignees shall succeed to all of Minnehoma's rights under its assignment from the Dealer and all of its rights hereunder.

13. The Dealer agrees that Minnehoma may make re- [fol. 39] newals or extensions of any installments from time to time, and may take such action as it sees fit to enforce its remedies under any contracts purchased by and assigned to it, or may refrain for any cause or without cause from taking any action against purchaser under any such contract without releasing the Dealer from his liabilities hereunder.

14. The failure of Minnehoma or its successors and assigns to exercise any right hereunder shall not operate as a waiver of such right and all rights and remedies contained herein shall be cumulative and not alternative.

15. Minnehoma shall in no manner whatsoever be responsible for the legal validity or sufficiency of any forms or instruments or other documents which Minnehoma, or its assigns, may furnish to the Dealer. Nor shall Minnehoma be responsible for any advice or information which it furnishes to the Dealer as to the legal requirements of the jurisdiction in which the Dealer operates or any other jurisdiction for the validity of contracts or filing requirements or other requirements thereunder. The obligation is upon the Dealer in each instance to comply with such laws irrespective of any advice received from Minnehoma.

16. All expenses in connection with filing of contracts or other documents for repossession of trailercoaches or otherwise arising from the making or enforcement of any contract or the assignment thereof shall be upon the Dealer, except to the extent paid by the purchaser.

17. In the event collection agency expenses are incurred or any legal action or proceeding is necessary to enforce any of Minnehoma's rights under any contract purchased by it or hereunder, the Dealer shall be responsible for all of the costs and expenses thereof, including reasonable attorney's fees, except to the extent that Minnehoma may recover the same from the purchaser.

[fol. 40] 18. No waiver or modification of this agreement shall be valid unless accepted by Minnehoma in writing.

19. This agreement shall be binding upon and inure to the benefit of the heirs, personal representatives, successors or assigns of the parties hereto. Either party hereto shall have the right at any time upon written notice to cancel this agreement as to future transactions and such cancellation shall in no manner affect the obligations of Dealer as to the instruments purchased prior to the effective date of cancellation.

20. This Agreement replaces and supersedes an agreement dated December 30, 1949 between Minnehoma and Dealer. It is hereby agreed that the terms and conditions of this contract shall and they hereby do cover and apply to all contracts heretofore purchased by Minnehoma from Dealer.

In Witness Whereof, the parties have caused this instrument to be duly executed under seal this 8th day of November, 1950.

.....

Dealer,

(For Individual Dealer),

(Corporate Seal)

Attest:

.....

Baird Trailer Sales,

Dealer,

By: Clifton Baird,

Part.;

Minnehoma Financial Company,

By: E. H. Gubser,

(Corporate Seal) *President.*

Attest:

(Illegible)

[fol. 41]

BEFORE THE TAX COURT OF THE UNITED STATES

EXHIBIT 13-M.

Minnehoma Financial Company
Spartan Branch
Tulsa, Oklahoma

December 21, 1950

Baird Trailer Sales
Highway No. 56
Salem, Indiana

Dear Dealer:

Changing conditions have required that some adjustments be made in the financing terms offered the dealers from whom we purchase contracts. There is no change in so far as the public is concerned. The only change is between you, the dealer, and Minnehoma Financial Company.

The change is in the amount of the finance charge that we have been crediting to your reserve account. As you know, this has been one-fifth of the finance charge on new trailers and one-sixth on used trailers. This is changed to

one-tenth on new trailers and one-twelfth on used trailers as of the beginning of 1951. This therefore is our notice to you that pursuant to the provisions of paragraph 7 of the Agreement Covering Purchase of Conditional Sales and Other Time Sales Contracts between us, this company has determined that effective January 1, 1951 the amount to be credited to your dealer reserve account shall be one-tenth on new trailers and one-twelfth on used trailers of the finance charge paid or agreed to be paid by the purchaser on each contract purchased from you.

For your protection we have been making a study of the Soldiers and Sailors Relief Act. We are preparing a form [fol. 42] of waiver as allowed by the Soldiers and Sailors Relief Act. A supply will be mailed to you in a few days. We will require a draft-free guarantor with proper credit standing on all sales to persons 32 years of age and under and all persons in any of the reserves.

With our best wishes for a Merry Christmas and a Happy New Year for you, we remain

Yours very truly,

Minnehoma Financial Company,
E. H. Gubser,
President.

EHG:np

BEFORE THE TAX COURT OF THE UNITED STATES

EXHIBIT 14-N.

Collateral Assignment.

For Valuable Consideration, the receipt of which is hereby acknowledged, the undersigned hereby sells, assigns, transfers, and conveys unto Michigan National Bank, of Grand Rapids, Michigan, its successors, and assigns forever, irrevocably, all of his, its, or their right, title and interest in certain sums of money now on deposit or that may hereafter be deposited in the Michigan National Bank, of Grand Rapids, Michigan, and identified and represented

by Reserve account in the name of the undersigned in the Michigan National Bank.

This Assignment and Transfer is made as collateral security for the payment of the direct and indirect liability of the undersigned to the said Michigan National Bank, of Grand Rapids, Michigan, and to secure the payment of the several notes representing said direct and indirect liability and any renewal or renewals thereof, or any installment payment or payments and to secure any obligation which [fol. 43] may arise which the undersigned may owe to said Michigan National Bank, of Grand Rapids, Michigan.

In the event of default in the payment of said liability or any installment thereof, or any of the several notes at the time when same shall fall due or in the payment of the interest thereon or any part of the principal of said liability then the Michigan National Bank, of Grand Rapids, Michigan, at their election, notice of said election being hereby expressly waived, may apply the total of said sums of money represented by said Reserve account at the date of election or any part thereof to meet the default in the liability.

Whenever the indebtedness secured hereby is paid in full the Michigan National Bank, of Grand Rapids, Michigan, shall reassign said sums of money represented by said Reserve account along with all right, title and interest back to the undersigned.

If in the opinion of the bank the undersigned dealer's account is in good standing, all sums in this reserve account in excess of ten per cent (10%) of the gross unpaid balance of all contracts outstanding on February 28 of each year will promptly be returned to the undersigned dealer.

In Witness Whereof said party has hereunto set his, its, or their hand and seal this 14 day of July, 1949.

Witness:

Clifton Baird partner of Baird Trailer Sales (L.S.)

[fol. 44]

BEFORE THE TAX COURT OF THE UNITED STATES

EXHIBIT 16-P.

Midland Discount Company
1100 First National Bank Bldg.
Cincinnati 2, Ohio

J. Page Hayden H. R. La Bar

December 18, 1951

Baird Trailer Sales
Salem, Ind.

Gentlemen:

We are pleased to inform you that your account has been approved for credit by our company.

Our standard retail terms provide for a down payment of 33⅓% of the cash selling price, in all cases; a maximum maturity of 48 mos. on new trailers; 30 mos. on used trailers selling for $2,500 or more, and 24 mos. for all other used trailers. The retail paper is to be endorsed by you with recourse.

Our advance on new trailer paper will be for 97% on the unpaid cash balance and on used trailer paper, for 95% on the unpaid cash balance. The differentials of 3% and 5% will accumulate to provide you with a loss reserve. When this reserve fund exceeds 10% of your outstandings, the excess will be paid to you automatically.

We have enclosed samples of our unpaid balance charts and insurance rates. All trailers are to be insured for fire, theft and combined additional coverage and vendors' single interest conversion. We do not require collision insurance if an executed "Trailer Use Certificate" accompanies the transaction. If the trailer is to be used in such a way that this Certificate does not apply, $100 deductible collision insurance should be provided.

[fol. 45] The original conditional sale contract, note, filing copy, manufacturer's copy of invoice on new trailers, completed credit application and a written credit report from a

recognized agency should be mailed to this office for approval and purchase. You should apply for and have sent to us the title certificate showing the proper encumbrance in our favor.

The Indiana intangible tax will be deducted from the proceeds of each retail transaction and we will furnish you with evidence of its payment.

We are shipping you an initial supply of all necessary forms under separate cover. If you need a larger supply of any forms, please inform us and we will send them immediately.

Please do not hesitate to call or write to us about any phase of our plan which is not entirely clear to you.

We believe that our trailer finance plan will meet your needs and we hope that this will mark the beginning of a long and friendly business relationship.

Yours very truly,

Midland Discount Company,
H. R. Thompson,
Manager, Trailer Finance Division.

HRT:kby

[fol. 46]

BEFORE THE TAX COURT OF THE UNITED STATES

EXHIBIT 18-R.

Midland Discount Company
1100 First National Bank Bldg.
Cincinnati 2, Ohio

June 4, 1952

Baird Trailer Sales
Highway #56 West
Salem, Indiana

Gentlemen:

Our company entered the field of trailer coach financing late in December of 1951. We are highly pleased with the

quality of paper offered to us thus far and with the exceptionally fine cooperation of our dealer friends.

When we approved your account we promised you that we would improve our plan from time to time as our experience warranted. We are happy to announce the first of such improvements.

Beginning on June 10th, we will set up a dealer profit reserve equal to 1% of the unpaid cash balance of each retail contract. This profit reserve will be derived from the service charge and it will be paid to the dealer when the retail contract is paid out.

Effective also on June 10th, the dealer reserves of 3% on new transactions and 5% on used transactions, will be paid to the dealer when the contract is paid out. This procedure will be followed on all types of payoffs, including payment by the purchaser at maturity, anticipation by the purchaser or payment by the dealer in the cases of trade-ins or repossessions.

We have attached samples of our new unpaid balance and insurance charts which include an optional Life, Health and Accident plan. Our revised credit application and work [fol. 47] sheet follows the rate chart and retail contract and will simplify the task of figuring retail transactions.

You will note from the new insurance supplement that the Vendors' Single Interest insurance rate has been increased from $9.50 to $12.50 on new trailers. The VSI coverage on used trailers remains as before. This coverage has been extended, however, to include Single Interest Collision insurance in addition to the Single Interest Conversion, Secretion and Embezzlement insurance. This improved coverage is for your protection but we urge you to sell trip collision insurance or term deductible collision insurance where the declared usage of the trailer indicates that these types of coverage are necessary for the protection of your customer. A supply of the new forms are being mailed to you under separate cover. If we have underestimated your needs, please call upon us for additional amounts.

We take this opportunity to thank you for the business which you have sent us and we hope that you will continue to find our finance service a valuable help to you in your business of retailing trailers.

Yours very truly,

Midland Discount Company,
H. R. Thompson,
Manager, Trailer Finance Division.

HRT:per

[fol. 48]

IN THE TAX COURT OF THE UNITED STATES

PORTION OF EXHIBIT 26-Z.

TESTIMONY OF WILLIAM McCLANE.

"Q. Why were these dealer reserve accounts set up?

"A. For the protection of the bank, which of course means the depositors, primarily; the stockholders, secondarily.

"It is quite possible in this business that the contingent liability of the dealer exceeds by a great many times his net worth. That was more true in 1948 and '49 than it is now. When we'd take on a dealer possibly worth ten thousand dollars, it was quite possible for him to have contingent liabilities of two or three hundred thousand dollars.

"I know of very few cases where the contingent liability of an active dealer does not greatly exceed his net worth, which isn't in cash; it's in his lot, his inventory, and so forth.

"We need reserves on which we can draw to avoid losses."

(pp. 31-32)

* * * * * * *

"Q. Is it also possible that Johnson's entire reserve might be wiped out in one year?

"A. Yes, through circumstances beyond his or our control: bad business conditions, insolvency on his part, or, what we are looking for or worrying about, is a drop in the resale market of used trailers, such as has happened

in the automobile business in the last year or year and a half.

"We are losing an average of three to four hundred dollars on every car we repossess. Should that happen in the trailer business, the only place that loss can come from [fol. 49] is this reserve. The dealers won't be able to stand to pay us back.

"We haven't had those times during the life of this industry, fortunately."

(pp. 61-62)

BEFORE THE TAX COURT OF THE UNITED STATES

T. C. Memo. 1957-192—Filed October 9, 1957

Docket Nos. 60132, 63907

CLIFTON E. BAIRD and VIOLET L. BAIRD, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Lester M. Ponder, Esq., and William L. Thompson, Esq., for the petitioners.

Robert E. Johnson, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT

These consolidated proceedings involve deficiencies in income tax of petitioners as follows:

Docket No.	Year	Deficiency
60132	1952	$16,499.72
	1953	23,086.16
63907	1954	7,434.72

The sole issue is whether certain amounts are taxable as income when earned and credited by finance companies to the dealer's reserve accounts of petitioners' accrual basis partnership. The other issue raised by the petition has been conceded by petitioners.

[fol. 50] Most of the facts have been stipulated and are found accordingly.

Petitioners are husband and wife residing in Salem, Indiana. They filed joint returns for the calendar years involved with the district director of internal revenue for the district of Indiana, on the cash basis.

Petitioners are equal partners, doing business under the name Baird Trailer Sales, hereinafter referred to as the partnership. It has engaged, since its organization in January 1947, in the sale of new and used mobile homes, usually referred to as house trailers, and to a lesser extent in new and used cars, parts and accessories, furniture, and real estate, in Salem, Indiana.

Partnership returns were filed for the fiscal years ended February 28, 1952, 1953, and 1954, and an amended return for the fiscal year ended February 28, 1952. The partnership kept its books and filed its income tax returns on an accrual method of accounting.

The partnership books reflected gross sales and cost of sales for the fiscal years ended February 28, 1952, 1953, and 1954, as follows:

	1952	1953	1954
Gross sales	$1,025,943.89	$1,337,385.64	$1,067,144.18
Cost of sales	859,746.75	1,141,308.59	908,027.87

During the taxable periods involved the partnership sold most of its trailers under conditional sales contracts. It sold such contracts to only three finance companies, namely: Minnehoma Financial Company, Tulsa, Oklahoma; Michigan National Bank, Grand Rapids, Michigan, and Midland Trailer Finance Corporation, hereinafter referred to as "Minnehoma", "Michigan", and "Midland", and collectively referred to as the "Finance Company" or, the "Finance [fol. 51] Companies." In such cases the purchaser executed a note payable to the partnership for the unpaid purchase price of the trailer, plus insurance, interest, and financing charges, and gave a chattel mortgage on the trailer as security. In the case of Minnehoma the contract took the place of the note payable.

Most of the notes accepted by the partnership in part payment for trailers were sold to one of the above-named companies in accordance with the terms of agreements between the partnership and each finance company. In the taxable years, the partnership handled its note business substantially with Midland.

The partnership and Minnehoma signed a document pertinent only to new trailer coaches manufactured by Spartan Aircraft Company, dated December 30, 1949, entitled "Agreement Covering Purchase of Conditional Sales Contracts" which contained inter alia, the following provisions:

> 1. The Dealer shall not be obligated to sell any conditional sales contracts to Minnehoma, but may offer Minnehoma such contracts as the Dealer may from time to time choose, and Minnehoma shall not be obligated to purchase or acquire any contracts offered for sale and assignment by the Dealer, but shall purchase only such contracts as it is willing to do. This agreement shall govern only the sale and assignment of such conditional sales contracts as the Dealer shall elect to sell and Minnehoma shall indicate its willingness to purchase and acquire.
>
> * * * * *
>
> 6. The purchase price of each conditional sale contract purchased by and assigned to Minnehoma hereunder shall be equal to the retail cash sales price of the trailer coach and all extra equipment plus all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance.
>
> 7. The Dealer unconditionally guarantees the pay-[fol. 52] ment of all sums required to be paid under each conditional sale contract purchased by and assigned to Minnehoma hereunder when such payment shall become due. In the event that the purchaser defaults or fails to pay any installment due under any conditional sale contract purchased by and assigned to Minnehoma hereunder, the Dealer agrees to demand of Minnehoma

to pay such sum then due or, upon request of Minnehoma, to re-purchase from Minnehoma for the entire balance remaining unpaid under said conditional sale contract. * * *

No provision appears in the 1949 agreement for the withholding of any dealer reserve by Minnehoma.

On November 8, 1950, the December 30, 1949 agreement was superseded by an "Agreement Covering Purchase of Conditional Sales and Other Time Sales Contracts."

Paragraph 6 and 7 of the 1950 agreement provide as follows:

> 6. The purchase price of each contract purchased by and assigned to Minnehoma hereunder shall be equal to 95% of the aggregate of the retail cash sales price of the trailercoach and all extra equipment and all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance.
>
> 7. An amount to be determined by Minnehoma from time to time in its absolute discretion equal to not more than 5% of the aggregate of the retail cash sales price of the trailercoach and all extra equipment and all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance will be credited by Minnehoma to a special reserve account in the name of the Dealer hereunder as to each contract purchased by and assigned to Minnehoma hereunder, which account will be referred to as the "Dealer Reserve Account". In addition, Minnehoma may credit to such Dealer Reserve Account hereunder, but shall [fol. 53] not be obligated so to do, one-fifth (1/5) on new trailers and one-sixth (1/6) on used trailers, or such other portions as Minnehoma may determine from time to time, of the finance charge paid or agreed to be paid by the purchaser in each contract. In addition to and without affecting any or all of its rights hereunder,

Minnehoma may, at its option, charge against the Dealer Reserve Account any sums that the Dealer may at any time owe to Minnehoma in any connection whatsoever. In the event and at such time or times as the Dealer Reserve Account shall exceed 15% of the aggregate unpaid balances of all contracts purchased by and assigned to Minnehoma hereunder by the Dealer plus all contingent liabilities which, on the sole determination of Minnehoma, it may have with respect to such contracts, Minnehoma will pay such excess to the Dealers from time to time as determined by Minnehoma but not more frequently than once each month. In the event that and at such time as all contracts as shall have been purchased and assigned to Minnehoma by the Dealer shall have been paid in full and no sum shall remain unpaid thereunder and in the opinion of Minnehoma there shall be no contingent liability on the part of Minnehoma with relation thereto, Minnehoma shall pay to the Dealer the balance of the credit in such Dealer Reserve Account. Minnehoma's determination as to the possibility of contingent liability shall be final and not subject to question by the Dealer.

Credits to the dealer reserve account in amounts usually five per cent of the aggregate retail cash sales price of the trailer were entered on the books of Minnehoma. The 1950 agreement continued to provide that the dealer-partnership "unconditionally guarantees the payment of all sums required to be paid under each contract purchased by and assigned to Minnehoma hereunder when such payment shall become due."

On December 21, 1950, the amount of finance charge that Minnehoma had been crediting to the partnership's reserve account was changed from one-fifth to one-tenth on [fol. 54] new trailers, and from one-sixth to one twelfth on used trailers, effective January 1, 1951.

The written portion of the agreement between the partnership and Michigan is contained in a "Collateral Assignment" providing, in part, as follows:

For Valuable Consideration, the receipt of which is hereby acknowledged, the undersigned hereby sells,

assigns, transfers, and conveys unto Michigan National Bank, of Grand Rapids, Michigan, its successors, and assigns forever irrevocably, all of his, its, or their right, title and interest in certain sums of money now on deposit or that may hereafter be deposited in the Michigan National Bank, of Grand Rapids, Michigan, and identified and represented by Reserve account in the name of the undersigned in the Michigan National Bank.

This Assignment and Transfer is made as collateral security for the payment of the direct and indirect liability of the undersigned to the said Michigan National Bank of Grand Rapids, Michigan, and to secure the payment of the several notes representing said direct and indirect liability and any renewal or renewals thereof, or any installment payment or payments and to secure any obligation which may arise which the undersigned may owe to said Michigan National Bank, of Grand Rapids, Michigan.

In the event of default in the payment of said liability or any installment thereof, or any of the several notes at the time when same shall fall due or in the payment of the interest thereon or any part of the principal of said liability then the Michigan National Bank, of Grand Rapids, Michigan, at their election, notice of said election being hereby expressly waived, may apply the total of said sums of money represented by said Reserve account at the date of election or any part thereof to meet the default in the liability.

Whenever the indebtedness secured hereby is paid in full the Michigan National Bank, of Grand Rapids, Michigan, shall reassign said sums of money represented by said Reserve account along with all right, title and interest back to the undersigned.

[fol. 55] If in the opinion of the bank the undersigned dealer's account is in good standing, all sums in this reserve account in excess of ten per cent (10%) of the gross unpaid balance of all contracts outstanding on February 28 of each year will promptly be returned to the undersigned dealer.

The above agreement did not contain the provisions by which amounts representing a percentage of the aggregate sales price of the trailers or amounts representing a percentage of the finance charge were credited to the partnership's account on the finance company's books.

The written portion of the original agreement between the partnership and Midland is embodied in two letters dated December 3 and 18, 1951, containing, in part, the following:

> * * * The retail paper is to be endorsed by you with recourse.
>
> Our advance on new trailer paper will be 97% on the unpaid cash balance and on used trailer paper, for 95% on the unpaid cash balance. The differentials of 3% and 5% will accumulate to provide you with a loss reserve. When this reserve fund exceeds 10% of your outstandings, the excess will be paid to you automatically.

On and after June 10, 1952, the partnership notes were sold to Midland under the terms of a letter from Midland dated June 4, 1952, which provides, in part, as follows:

> Beginning on June 10, we will set up a dealer profit reserve equal to 1% of the unpaid cash balance of each retail contract. This profit reserve will be derived from the service charge and it will be paid to the dealer when the retail contract is paid out.
>
> Effective also on June 10, the dealer reserves of 3% on new transactions and 5% on used transactions, will be paid to the dealer when the contract is paid out. This procedure will be followed on all types of payoffs, including payment by the purchaser at ma- [fol. 56] turity, anticipation by the purchaser or payment by the dealer in the cases of trade-ins or repossessions."

Under the terms of its agreements with the three finance companies, the partnership sold most of its trailer notes to the finance companies for the deferred purchase price of the trailers plus in certain cases a percentage of the inter-

est or finance charges. As each note was transferred to it with recourse, the finance company remitted to the partnership the amount due it on the selling price of the trailer as above-described, less an amount which was credited on its books to an account in the name of the partnership designated "Dealer Reserve Account" by Minnehoma and Midland and designated "Dealer Escrow Account" by Michigan. Hereinafter, the use of the phrase "Dealer Reserve Account" includes the phrase "Dealer Escrow Account." The amount withheld and credited to such account was usually 5 per cent of the unpaid balance on each note, or with some finance companies on a new trailer only 3 per cent of the unpaid balance of the note. Further, in certain instances, Minnehoma and Midland also credited to the partnership's account a portion of the finance charge. At the time of sale, the finance companies sent the partnership a memorandum of the amount thus withheld and credited. The partnership also received periodic statements of the balances in the accounts designated "Dealer's Reserve" or "Dealer's Escrow Account" from the finance companies.

On the sale of a note, the partnership always endorsed the note to the finance company either with recourse and/or with their guaranty of the unpaid balance of the note.

The agreements with the three finance companies either oral or written contained the following provisions:

(a) In the event the retail purchaser's contract became due and unpaid, the finance company could charge [fol. 57] the account of the partnership designated "Dealer Reserve" with the unpaid balance;

(b) In the event the partnership had a matured financial obligation of any nature to the finance companies, the amount of such obligation could be charged to the partnership's account designated "Dealer Reserve";

(c) Repossession losses of the finance companies could be charged to the account of the partnership designated "Dealer Reserve";

(d) The ultimate balance in the account of the partnership designated "Dealer Reserve" after payment of all notes by the partnership to the finance companies was to be paid to the partnership; and

(e) Each finance company could look to the balance in the account designated "Dealer Reserve" of the partnership to satisfy any default by the partnership on its guaranties and obligations to the finance company, as well as any default by the makers of the notes.

The written portion of the foregoing agreements was prepared by the finance companies. The partnership was not required by the finance companies to do business with one company to the exclusion of other companies who dealt in paper of the nature of that purchased from the partnerships.

The partnership was not financially able to carry the contracts of sale or the floor plan and carry the inventory of trailers held for sale, but relied upon finance companies and certain banks.

The accounts on the finance company's books designated "dealer's reserve" for the partnership were reflected as a liability of the finance company and the annual balances in such accounts were not reflected in the income of the finance company.

During the years here involved, the partnership (by way of illustration) recorded the sale of a trailer and the sale of the note on its books and records as follows:

[fol. 58] Sales Receipt Journal Entry

Cash and or Trade-in Allowance	$1,745.00	
Contracts Receivable—Finance Company	3,800.00	
Trailer Sales		$5,545.00

When the finance company remitted the check, the following entry was made:

Reserve—Finance Company	$ 190.00	
Cash	3,632.67	
Expense for Intangible Stamps	1.38	

Contracts Receivable		$3,800.00
Expenses (Credit Check)		24.05
		$3,824.05
Cost of Sales	$3,824.05	
Credit Inventory		$3,824.05

When a purchaser defaulted on his contract and note, the trailer was repossessed upon receipt of notice of default. The partnership always paid the finance company the unpaid balance due on such note and recorded such payment on its books and tax returns as a purchase. Where defaults occurred on the notes payable to the partnership, the payments paid to the finance companies as a result of the defaults were included on the partnership's fiscal year 1952, 1953, and 1954 returns as part of the cost of goods sold. On resale of the repossessed trailer, the receipts therefrom were reported as gross receipts. For example, if a trailer costing $5,545 with notes payable outstanding of $3,500 was repossessed and the trailer's fair market value was only $3,000, the loss, if any, was reflected on the partnership's books and records as part of cost of goods as follows: The bookkeeper of the partnership either on the date of repos- [fol. 59] session or at the close of the fiscal year charged $500 to overallowance on trailers and recorded the purchase price of the trailer in cost of used trailers at $3,000 (its fair market value). However, if the trailer was sold during the fiscal year in which it was repossessed, and the bookkeeper had not charged $500 to overallowance on trailers, the purchase price of the trailer was reflected in cost of used trailers at $3,500, and the sales price of $3,000 reported in gross receipts. In the event the notes payable outstanding were $3,000 or less in the above example, the purchase price of the trailer was reflected in cost of used trailers at the amount paid by the partnership on the unpaid balance of the note payable. The finance company remitted to the partnership the amount which had been credited to the account designated "Dealer Reserve" with respect to such defaulted contract and note and the partnership reported such amount in taxable income for the year

of receipt except for the years 1947 and 1948, when the credit to the amounts designated "Dealer Reserve" were included in taxable income.

During the fiscal years ended February 28, 1952, 1953, and 1954, Minnehoma, Michigan, and Midland credited the following total amounts in the account of the partnership designated "Dealer's Reserve" on the books of such companies.

1952	$25,816.58
1953	29,560.54
1954	29,660.49

During the fiscal years ended February 28, 1952, 1953, and 1954, the partnership received the respective amounts of $1,217.94, $1,778.94, and $9,141.39 from finance companies out of its accounts designated "Dealer Reserve" on the books of the finance companies including Union Bank of Michigan, Pioneer Finance Company, Kent Bank, and [fol. 60] Evansville Morris Plan to which the partnership had sold notes.

On its returns for the taxable years 1952, 1953, and 1954, the partnership deducted specific bad debts in the respective amounts of $1,203.75, $2,239.12, and $1,203.69, a portion of such deductions were unpaid amounts due the partnership for accessories, supplies, and repairs. The remainder consisted of advances by the partnership to meet trailer purchaser's payments which the purchaser was unable to make and after advancement a default by the purchaser occurred.

In computing the gross receipts reported in its returns for the taxable years involved, the partnership deducted the total amount credited by the finance companies in each year to the partnership's account designated "dealer's reserve" from gross sales to arrive at the amount reported as gross receipts on its returns. Respondent included such amounts in the partnership's income.

In determining the contested deficiencies, the respondent reduced the total amounts credited by the finance companies to the partnership dealer's reserve account by the amounts received by the partnership from the finance companies in

the respective taxable years, and added the net amounts to the partnership income.

Opinion

LeMire, Judge: The question presented is whether the amounts credited by finance companies to a dealer's reserve account of petitioners' accrual basis partnership constitute income in the year credited or in the year the partnership is entitled to payment.

The amounts involved are not in dispute. Most of the facts are stipulated, together with certain testimony from the *Blaine & Evelyn K. Johnson* case, Docket No. 52306, [fol. 61] 25 T. C. 123, and set forth in exhibit 26-Z, received in evidence herein.

The record and the facts found herein bring the instant case within the ambit of our decisions holding that amounts credited by financing institutions to a "dealer's reserve" account of an automobile or trailer dealer on an accrual basis of accounting are income in the year credited. *Shoemaker-Nash, Inc.*, 41 B. T. A. 417; *Blaine Johnson, supra; Albert M. and Lucille Brodsky*, 27 T. C. 216; *Texas Trailercoach, Inc.*, 27 T. C. 575, on appeal [C. A.-5]; *West Pontiac, Inc.*, 27 T. C. 749, on appeal [C. A.-5].

Petitioners rely upon the reversal of the *Blaine Johnson* case, *supra* (C. A.-4), 233 F. 2d 952.

The *Blaine Johnson* case, *supra*, reversal has been reexamined in the recent cases of *Albert Brodsky, supra, Texas Trailercoach, Inc., supra*, and *West Pontiac, Inc., supra*, and with due deference to the views expressed by the Circuit Court, we have adhered to our own decisions, and so follow them in the present proceeding.

We, therefore, sustain the respondent's determinations that the uncontroverted amounts credited to the dealer's reserve account of petitioners' partnership in the respective taxable years ended February 28, 1952, 1953, and 1954, constitute income of the partnership distributable to petitioners.

Decisions will be entered for the respondent.

[fol. 62]

BEFORE THE TAX COURT OF THE UNITED STATES
Washington

Docket No. 60132

CLIFTON E. BAIRD and VIOLET L. BAIRD,
(Husband and Wife), Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

DECISION—Entered October 11, 1957

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion filed October 9, 1957, it is Ordered and Decided: That there are deficiencies in income taxes for the years 1952 and 1953 in the respective amounts of $16,499.72 and $23,086.16.

Enter:

Eugene Black, Judge.

(Seal)

[fol. 63]

BEFORE THE TAX COURT OF THE UNITED STATES
Washington

Docket No. 63907.

CLIFTON E. BAIRD and VIOLET L. BAIRD,
(Husband and Wife), Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

DECISION—Entered October 11, 1957.

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion filed

October 9, 1957, it is Ordered and Decided: That there is a deficiency in income tax for the year 1954 in the amount of $7,434.72.

Enter:

Eugene Black,
Judge.

(Seal)

[fol. 64]

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 60132.

CLIFTON E. BAIRD and VIOLET L. BAIRD,
Husband and Wife, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 63907.

CLIFTON E. BAIRD and VIOLET L. BAIRD,
Husband and Wife, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION FOR REVIEW—Filed December 5, 1957

Clifton E. Baird and Violet L. Baird, Husband and Wife, Petitioners in Causes No. 60132 and 63907 in the Tax Court of the United States, by their counsel, Lester M. Ponder, hereby file their Petition For Review by the United States Court of Appeals for the Seventh Circuit of the Decision of the Tax Court of the United States, rendered October 11, 1957, Memorandum Opinion 1957-192, determining deficiencies in income tax against said Clifton

E. Baird and Violet L. Baird for the taxable years 1952, 1953 and 1954 in the amounts of $16,499.72, $23,086.16 and $7,434.72, respectively.

I.

Jurisdiction and Venue.

The returns of income tax in respect to which the aforementioned income tax liabilities arose were filed by Petitioners, Clifton E. Baird and Violet L. Baird, with the [fol. 65] District Director of Internal Revenue for the District of Indiana, which is located within the jurisdiction of the United States Court of Appeals for the Seventh Circuit. The said Clifton E. Baird and Violet L. Baird are and were at the time said returns were filed, residents of the City of Salem, State of Indiana, which is located within the jurisdiction of the United States Court of Appeals for the Seventh Circuit. This Court has jurisdiction under sections 7482 and 7483 of the Internal Revenue Code of 1954.

II.

Nature of the Controversy

The controversy involves a proper determination of the income tax liability of Clifton E. Baird and Violet L. Baird for the taxable years 1952, 1953 and 1954. The two Tax Court cases, Docket No. 60132 and 63907, involve the same issue and were consolidated for hearing and decision by the Tax Court. The Petitioners, Clifton E. Baird and Violet L. Baird, were equal partners during the taxable years 1952, 1953 and 1954, doing business as Baird Trailer Sales. This partnership used a fiscal year ending on the last day of February and kept its books and records and filed its income tax returns on the accrual method of accounting.

The sole question in issue in these consolidated cases is whether amounts credited by certain finance companies to accounts on their records designated "Dealer Reserve Accounts" in the name of the partnership known as "Baird Trailer Sales", are accruable as taxable income by

the partnership in the year in which the partnership is entitled to payment, or in the year of such credit by the finance companies. The Commissioner determined deficiencies for each of the years in question by adopting the latter position.

[fol. 66] The Petitioners, Clifton E. Baird and Violet L. Baird, filed petitions in the Tax Court of the United States seeking a redetermination of their income tax liability for the taxable years 1952, 1953 and 1954, and a hearing was held before the Tax Court at Cincinnati, Ohio, on April 29, 1957.

On October 11, 1957, the Tax Court of the United States entered its decision in these cases. It held that the amounts credited by the finance companies in the name of the partnership were reportable as income in the years of credit, even though the partnership was not entitled to payment until later years, if at all, under certain contingent provisions of its contracts with the finance companies.

Lester M. Ponder.

Barnes, Hickam, Pantzer & Boyd, 1313 Merchants Bank Building, Indianapolis 4, Indiana, Of Counsel.

Duly sworn to by Lester M. Ponder, jurat omitted in printing.

[fol. 67]

IN THE UNITED STATES COURT OF APPEALS

(Caption—60132-63907)

NOTICE OF FILING PETITION FOR REVIEW—December 5, 1957

To: Nelson P. Rose,
Chief Counsel,
Internal Revenue Service.

You are hereby notified that the above named Petitioners did, on the 5th day of December, 1957, file with the Clerk of the Tax Court of the United States, at Washington, D. C., a Petition For Review by the United States Court of Appeals for the Seventh Circuit, of the decision of this Court

heretofore rendered in the above-entitled cases. Copy of the Petition For Review as filed is hereto attached and served upon you.

This 5th day of December, 1957.

Howard P. Locke, Clerk, Tax Court of the United States.

Service of copy of Petition For Review acknowledged this 5th day of December, 1957.

Nelson P. Rose, Chief Counsel, Internal Revenue Service, Attorney for Respondent.

[fol. 68A] [File endorsement omitted]

[fol. 69]

Appendix to Respondent's Brief—Filed April 9, 1958

BEFORE THE TAX COURT OF THE UNITED STATES

Docket No. 60132

CLIFTON E. BAIRD and VIOLET L. BAIRD,
Husband and Wife, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

DOCKET ENTRIES

1955

Nov. 7—Petition received and filed. Taxpayer notified. Fee paid.

Nov. 8—Copy of petition served on General Counsel.

Dec. 15—Answer filed by Respdt.

Dec. 15—Request for hearing in Indianapolis filed by Respdt.

1955

Dec. 20—Notice issued placing proceeding on Indianapolis calendar. Service of answer and request made.

1956

May 31—Motion for withdrawal of Lewis N. Angermeier and Adrian E. Wilhoite, as counsel, filed. 5/31/56 granted.

Aug. 6—Entry of appearance of William L. Thompson, as counsel, filed.

Jun. 14—Motion of May 31 served.

1957

Feb. 25—Entry of appearance of Lester M. Ponder, as counsel, filed.

Mar. 4—Motion to change place of hearing to Cincinnati, Ohio, and place it on the next cal. at Cincinnati, Ohio, filed by Petr. 3/5/57 granted as to place of hearing. Served 3/8/57.

[fol. 70]

Mar. 22—Hearing set 4/29/57, Cincinnati, Ohio. Served 3/21/57.

Apr. 29—Hearing had before Judge LeMire on the merits. Consolidated. Submitted. Stipulation of facts filed. Petitioners' brief due June 13, 1957. Respondent's reply brief due July 29, 1957. Petitioners' reply brief due Aug. 19, 1957.

May 21—Transcript of hearing April 29, 1957 filed.

Jun. 12—Brief for petitioners filed. Served 6/12/57.

Jul. 29—Answer brief filed by respondent.

Aug. 12—Reply brief for petitioners filed. Served 8/22/57.

Oct. 9—Memorandum findings of fact and opinion filed, LeMire, J. Decision will be entered for Resp. Served 10/10/57.

Oct. 11—Decision entered, J. Black. Served 10/14/57.

Nov. 1—Order fixing amount of Bond at $65,000.00 entered. Served 11/4/57.

1957
Dec. 5—Petition for review by U.S. Ct. of Ap. 7th Cir. filed by Petrs.

Dec. 5—Notice of filing petition for review with proof of service thereon, filed.

Dec. 19—Designation of contents of record on review with proof of service thereon, filed.

[Caption omitted]

Docket No. 63907

Docket Entries

1956
Aug. 22—Petition received and filed. Taxpayer notified. Fee paid.

Aug. 23—Copy of petition served on General Counsel.

[fol. 71]
Aug. 22—Request for Circuit hearing in Indianapolis filed by Petr. 8/23/56 granted. Served 8/23/56.

Sept. 13—Answer filed by Resp. Served 9/17/56.

1957
Mar. 4—Motion to change place of hearing to Cincinnati, Ohio, and place on the next Cincinnati, Ohio, cal. filed by Petitioner. 3/5/57 granted as to change of place of hearing.

Mar. 22—Hearing set 4/29/57, Cincinnati, Ohio. Served 3/21/57.

Apr. 29—Hearing had before Judge LeMire on the merits. Consolidated. Submitted. Stipulation of facts filed. Petitioners' brief due June 13, 1957. Respondent's reply brief due July 29, 1957. Petitioners' reply brief due Aug. 19, 1957.

May 21—Transcript of hearing April 29, 1957, filed.

Jun. 12—Brief for petitioners filed. Served 6/12/57.

The following table shows the amounts credited on the books of said finance companies in the dealer reserve accounts of the partnership and the amounts it received [fol. 91] from those and other finance companies in the years indicated:

Fiscal year ended February 28	Credited by said finance companies in dealer reserve accounts of partnership	Received by partnership from all finance companies
1952	$ 25,816.58	$ 1,217.94
1953	29,560.54	1,778.94
1954	29,660.49	9,141.39

On its returns for the relevant years, the partnership deducted specific bad debts in the respective amounts of $1,203.75, $2,239.12, and $1,203.69. Such deductions included unpaid amounts due the partnership for accessories, supplies and repairs. But what is significant here is that such deductions also included advances by the partnership to meet trailer purchaser's payments which the purchaser was unable to make and after advancement a default by the purchaser occurred.

In computing the gross receipts reported in its returns for the relevant years, the partnership deducted from gross sales the total amount credited by the finance companies in each year to the partnership's account desig-

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used trailers at $3,000 (its fair market value). However, if the trailer was sold during the fiscal year in which it was repossessed, and the bookkeeper had not charged $500 to overallowance on trailers, the purchase price of the trailer was reflected in cost of used trailers at $3,500, and the sales price of $3,000 reported in gross receipts. In the event the notes payable outstanding were $3,000 or less in the above example, the purchase price of the trailer was reflected in cost of used trailers at the amount paid by the partnership on the unpaid balance of the note payable. The finance company remitted to the partnership the amount which had been credited to the account designated "dealer's reserve" with respect to such defaulted contract and note and the partnership reported such amount in taxable income for the year of receipt, except for the years 1948 and 1949, when the credit to the amounts designated "dealer's reserve" were included in taxable income.

1957

Jul. 29—Answer brief filed by resp.

Aug. 12—Reply brief for petrs. filed. Served 8/22/57.

Oct. 9—Memorandum findings of fact and opinion filed, LeMire, J. Decision will be entered for resp. Served 10/10/57.

Oct. 11—Decision entered, J. Black. Served 10/14/57.

Nov. 1—Order fixing amount of Bond at $65,000.00 entered. Served 11/4/57.

Dec. 5—Petition for review by U. S. Ct. of Ap. 7th Cir. filed by Petrs.

Dec. 5—Notice of filing petition for review with proof of service thereon, filed.

Dec. 19—Designation of contents of record on review with proof of service thereon, filed.

[Fol. 72]

BEFORE THE TAX COURT OF THE UNITED STATES

Transcript of Testimony in Docket Nos. 60132 and 63907 (Excerpts from)

CLIFTON EUGENE BAIRD was called as a witness on behalf of the Petitioner and having been first duly sworn, testified as follows:

Cross Examination.

By Mr. Johnson:

Q. Mr. Baird, I believe you stated you sold mobile homes or trailers. When you sold, I'll call them trailers for convenience, when you sold such trailers to a purchaser, who was present?

A. When I sold the trailer, there would be myself, and the customer, and such other people as worked in our organization.

Q. And the other people, what would those be? The salesman that might have sold the trailer? I don't know

nated "dealer's reserve". However, the Commissioner included such amounts in the partnership's income. In determining the contested deficiencies, the Commissioner reduced the total amounts credited by the finance companies to the partnership dealer's reserve accounts by the amounts received by the partnership from the finance companies in the relevant years, and added the net amounts to the partnership income.

No delinquent notes were charged to the partnership's dealer's reserve accounts by any finance company during the relevant years. During these years the finance companies were in such good financial condition that they were able to pay any accounts which might have been due and payable to the partnership out of the dealer's reserves.

The Tax Court held that the amounts of the dealer's reserves withheld by the finance companies during the relevant years and credited to the partnership's account [fol. 92] on the finance companies' books were includible in taxpayers' taxable income in the years withheld and credited.

Taxpayers argue that the amounts withheld by finance companies and credited to dealer's reserve accounts on their books are not accruable in the year of withholding because extreme contingencies rendered most uncertain the right of taxpayers to such amounts; that the agreements between the partnership and each of the finance companies severely restricted the right of the petitioners to the amounts withheld; that the holdback and other restrictive provisions of these agreements were dictated by the finance companies to protect themselves against losses; that the partnership was forced to acquiesce in these unfavorable terms in order to do business with the finance companies; and that the credits in the dealer's reserve accounts were not partnership assets. Finally they argue that the trailer contracts and notes were sold by the partnership solely because of its immediate needs for cash funds, since the business would have been much more profitable if the partnership had been financially able to retain such paper.

The Commissioner argues, in part, that the Tax Court correctly held that amounts withheld by finance companies, in purchasing trailer and automobile notes and contracts

what other people would be in your organization, what you mean by that.

A. We have managers, assistant managers, service managers, sales people, bookkeepers, secretaries.

Q. Now, at the time when a purchaser agreed to take a trailer did you put anything down in writing at that time?

A. Yes, sir.

Q. Is it the conditional sales contracts referred to in the stipulation?

A. That's a part of it, yes, sir.

Q. Well now at the time that they agreed, was there any representative of the finance company present?

[fol. 73] A. Not necessarily.

Q. You say "not necessarily." The finance companies did not have any paid employee on your premises, did they?

A. Not at all times, no.

Q. Well, for instance, now, how many times did a man from their office approximately visit you during these years involved?

A. That would only be a guess, sir, if I'd answer it. It's very negligible. Not too many times.

Q. By "not too many" how many do you mean? Two times in a year, or one time in a month?

A. There is no particular numbers of times. They could come a dozen times, once a year, and once the next, if they wanted to.

Q. And the same is true for your other finance companies that you dealt with; Midland?

A. Yes, sir.

Q. To be particular. And, Michigan National Bank, I believe?

A. Yes, sir.

Q. Now at the time that the purchaser agreed to take the trailer, did you know for sure if, which finance company you were going to sell their note to, their unpaid portion of the trailer purchase, say they'd put in a down payment and the rest was an unpaid portion and you took a note payable to you, is that correct?

A. That's the way the contracts were written, yes, sir.

Q. Now at the time they agreed to take the trailer, did you know for sure which finance company would buy that note?

A. In all cases?

Q. Yes.

A. No.

[fol. 74] Q. I take it from that, that you could—the partnership could sell these trailer notes to anyone that it pleased?

A. We weren't bound to any financing company. The contracts were a limiting factor.

Q. And the contracts you're referring to are those stipulated?

A. No, sir, the contracts with the financing companies.

Q. And those have been referred to by your counsel, and are in the stipulation of facts?

A. Conditional sales contracts.

Q. Do you have any other contracts, other than the—your counsel referred to?

A. Between myself and the customer. Conditional sales contracts.

Q. I see. You individually entered into a conditional sales contract with the purchaser of the trailer?

A. Various forms were used. All three forms were not usable by the same finance companies.

Q. Now if the partnership had wished to, and had been financially able, they could have retained these notes payable originally made out to them?

A. If we had been financially able.

Q. Now in the fiscal years of your partnership, February 28th, '48 and '49, were such dealer reserves carried on the books as an accounts receivable of your partnership?

* * * * * * *

A. I believe, yes.

By Mr. Johnson:

Q. That was your normal practice, at that time, in submitting financial statements to anyone, would you likewise, even though they were carried on the books, would you [fol. 75] likewise have carried them over to your financial statements that you submitted to any outside source?

A. I believe if they were carried as an accounts receivable, that they probably would have shown up on the financial statements for '48 or '49.

Q. Nor more specifically as to the years here involved, fiscal years February 28th, '52 and '53 and '54, did you keep the different financial companies that were buying your trailer notes, advised of the amount of dealer reserves with not only their finance companies, but with the other finance companies that they dealt with?

A. We reported to them, when they requested the information, yes, sir.

Q. And they periodically requested it, in the case of Midland was it once every six months or was it more often?

A. I don't believe there was a specific time element between reports.

Q. Well approximately how often, I saw, I happened to see two—

A. I would say approximately once a year, but that's an estimate, I hope you'll take it as such.

Q. Now you referred to Paragraph 20 and the amount showed under the columns "Unpaid balances" when you were talking to your counsel. Now in looking at those amounts, do you have records of your partnership from which you yourself, or it would be a bookkeeper in your employ, could have gone through all the notes sold to finance companies and the amounts paid back and determine those same figures?

A. No, sir.

Q. Do you—Have you destroyed the records of the partnership?

[fol. 76] A. We have not destroyed any records.

Q. Well, Mr. Baird, let me refresh your memory. At the time of a sale of a note, what information was kept on your partnership records?

A. There was too much information on my partnership records for me to remember them, sir. They're all in evidence.

Q. The partnership records are not in evidence, Mr. Baird. That's why I'm trying to bring it out. To be more specific, you know the unpaid balance on that note at the time you sold the note?

A. Yes, sir.

Q. And the partnership kept records of such unpaid balance, at the time of the sale, that was included in the records?

A. Sure.

Q. Now, whenever payments were made on that note, weren't you also kept advised periodically of—I don't know whether it's once a year or how many times a year, but periodically you'd be kept advised of the amount that had been paid off on the note, and what the unpaid balances were, from each finance company, each of these three finance companies?

A. For each individual note?

Q. No, from each of the three finance companies, these totals.

A. Gross totals, and direct liability, yes, when we requested the information.

Q. And also, the promissory note, you kept a record of how much the purchaser was to pay on that note? Well, I don't say whether it's a record. Did you keep a copy of the note?

A. No, sir.

Q. You didn't know how long the note was to run?

A. We knew how long the contract was written for, yes, sir.

[fol. 77] Q. And from that you could have found out what the payments were, because they were—

A. We knew how much his monthly payments were, because we had him sign the contracts, yes, sir.

Q. And at any time that a default occurred by the purchaser of the trailer?

A. Yes.

Q. Wasn't it the practice of the three finance companies that you dealt with, to notify you of that, so that you could make up those payments and avoid a re-possession?

A. No. I can't answer the whole question. With that.

Q. Do the best you can.

A. I'll try to answer any and all of your questions as well as I know how. If you'll take this in mind. I'm not an auditor and I'm not a lawyer.

Q. I'm not trying to hurry you. You take your time and tell what you know.

A. When a contract which we had sold to a customer, became delinquent, we received a copy of the delinquent notice, which was sent to the customer. When the delinquency run

on for maybe sixty days, or till it was deemed serious, we were asked to step into the collection efforts of the Company. If this contract could not be saved, a re-possession was made. Does that answer your question, sir?

Q. Yes, thank you, Mr. Baird. Mr. Baird, you referred to the necessity of submitting balance sheets, I believe, to banks. That was in regard to your direct testimony. By "banks" did you include the Michigan National Bank?

A. Yes, sir.

Q. That's one of the finance companies we've referred to?

A. Michigan National Bank—

Q. Yes?

[fol. 78] A. Was the people, one of the companies to whom we were selling trailer paper.

Q. Now, were there any other banks, other than Michigan National Bank?

A. We had to submit financial statements to my own bank, with which I did business at home, Farmer Citizens State Bank.

Q. Did they know about the dealer reserves, on what I would refer to as your finance company books, your Midland, Michigan, and Minnehoma Finance Companies?

A. They knew, and were very concerned, about the indirect liability created by sale of contracts and were also aware reserves were being held in escrow.

Q. Did they also express an interest in the amount of the reserves held by these finance companies?

A. Well, yes, sir, their interest would be in the indirect liability and the indirect reserves also.

Q. And specifically in the amounts of the reserves?

A. Sir, by that do you mean the amounts held or the accumulated balances?

Q. The accumulated balances.

A. Why, I'm sure they had an interest in it, yes, sir.

Q. Now, Dun & Bradstreet, you referred to that, you didn't borrow from Dun & Bradstreet?

A. No, sir, they're not a lending institution, I don't believe.

Q. Now, to straighten out something in my own mind, and it might be of interest to the Court. What is a floor plan?

A. A floor plan is a system used in keeping new trailers, also automobiles, and appliances, on dealer's showrooms or lots. It's a system under which the dealer borrows money, a floor plan of a new coach, usually consists of a percentage of the wholesale cost of the coach, car, or appliance, whatever it might be.

[fol. 79] Q. Now this is distinguished from your dealer reserves of the sale of the trailer notes, the floor plans?

A. They are not tied together in any way.

Q. Now did you borrow money for what I would call your floor plan?

A. Yes, sir, it was necessary.

Q. Did you borrow from three finance companies, Midland, Michigan, and Minnehoma?

A. Yes, sir.

Q. For the purposes of the floor plan?

A. Yes, sir.

Q. Were these substantial borrowings?

A. That's very—an indirect—in my case, they were substantial, as far as I'm concerned, they wouldn't to someone with a lot of money.

Q. In your balance sheets submitted with your returns, Exhibits 7-G, 5-E, and 6-F, are the figures shown on Page 4 under the schedule "Liabilities" under notes and mortgages payable, is that where you would have included that?

A. To the best of my knowledge, these would be included in this figure.

Q. Now in going through each one, well, we'll start with 7-G, the one for the fiscal year ended February 28th, '52, it's the amended return. You have an item of something like $56,800 some odd dollars. Is that the approximate amount of what I referred to as the floor plan?

A. If I can clear that better by a statement?

Q. Go ahead.

A. Ever since we started in business it was necessary for us to borrow money. Not only on our coaches, but on our real estate, and times even on our home, on any properties that we had. Not having the breakdown, I would say this mostly would have been the floor plan amount, but I'd hate to be bound to that, because I don't know the breakdown of it.

[fol. 80] Q. I see. There would have been some small other borrowings but your major borrowings would be for your floor plan?

A. Yes, sir.

Q. And is that the same true in Exhibits 5-E and 6F?

A. Yes, sir, the total liability figure would have shown all indebtedness of the partnership which included mortgages, loans, even personal loans. In other words, we borrowed quite a bit of money from various sources, floor plan included.

Q. And your floor plans would have been the substantial portion included in this figure, on your returns, would be the largest?

A. Would have been a substantial figure. Yes.

Q. Now can you give me an estimate of what portion of your floor plans in these years involved, '52, '53, and '54, were financed with the three finance companies I mentioned, Midland, Minnehoma, and Michigan National, as opposed to any other, I believe you mentioned a local bank, the name has escaped me.

A. Sir, I'm sorry, I can't give you the percentages. I did borrow from our local bank, on notes, and on secured obligations, and even, I said on notes, at times, but I can't give you the percentages, I didn't know it would be necessary.

Q. Well, I don't mean an exact percentage.

A. I can't give you.

Q. Did you borrow more from the three finance companies than from this local bank?

A. I believe that would be a fair statement. Yes.

Q. Now I'll show you the stipulation of facts, Paragraph 21, with certain figures here set forth as the total amounts credited to the account of the partnership designated dealer's reserve.

Now, those are total amounts for three companies. If [fol. 81] called upon, could you or your bookkeepers, from the records available to you, have broken these amounts down as between the three companies? I'm not asking you to do it now. As I understand, it would have taken your bookkeepers two or three days to have done it for the purposes of trial?

A. My opinion is that it could have been done.

Q. Do you know approximately, we've mentioned three companies, and we haven't set out the detailed amounts credited by each but, in these years, were you swinging, I don't know, substantially to the Midland Company, located here in Cincinnati?

A. I believe that would be a true statement, yes, sir.

Q. And Minnehoma, those were dropping off because they were limited only to, I think, Spartan trailers, weren't they?

A. We still do business with Minnehoma.

Q. Mr. Baird, there is a reference in one of the stipulations, to skip insurance. Could you explain that term in more detail?

A. I'll do the best I can, sir. In case, we as dealers sold a mobile home on a conditional sales contract, to someone and these people took it to a distant state, or even local state as far as that's concerned, the trailer and the customer could not be found after a designated period of time, was behind on his accounts, we were permitted to make a claim or have the financing company make it for us against what you referred to as a skip insurance policy.

If this was substantiated, the customer and the trailer could not be found, the insurance company was obligated to pay off the indebtedness of the conditional sales contract, after having received the premium, which was charged at the time.

Q. Let me ask. You said, if the customer and the trailer could not be found?

[fol. 82] A. Right.

Q. Then they would pay off?

A. Skip.

Q. Did you usually carry such skip insurance on your trailers during these years, '52, '53, and '54?

A. I believe they were included on all contracts.

Q. Now during these fiscal years, February 28th, '52, '53, and '54, did the partnership have occasion to recover on any of this skip insurance?

A. I'd hate to pin it down to one of those years. I know that recovery has been made by skip insurance, but I can't designate the year or years in which it was used.

Q. Did that occur on only one occasion, I believe?

A. No, there's been more than—there's been numerous occasions.

Q. These years involved?

A. I can't pin it down to the years. There might be broader coverage of the policy. Rather than the loss of the whole trailer, there is probably a clause in there which would pay, if part of the coach or part of its equipment was gone. I'm sure that there would be some insurance, in some form, for that type of loss.

Q. In those cases where there was such a loss, then you would have recovered from the insurance company and not claimed it as a loss on your return?

A. When there was an insurance loss the insurance company would have paid.

* * * * * * * *

JOSEPH HAYDEN was called as a witness on behalf of the Petitioner and having been first duly sworn, testified as follows:

* * * * * * *

[fol. 83] Cross Examination.

* * * * * * *

By Mr. Johnson:

Q. Do you have 18-R in your—so you'll have Exhibits 16-P, 15-O and 18-R in your possession, in regard to this ten per cent of your outstandings that was referred to on direct, that, in effect, was modified by Exhibit 18-R, was it not, Mr. Hayden?

A. Yes, sir.

Q. So that, beginning June 10th, whenever a dealer's contract or note was paid out, why, then that portion of the dealer reserve on that particular note was returned to the dealer?

A. That's correct, sir, on a monthly basis.

Q. And that was very beneficial to the dealer, was it not?

A. Well, it would be my opinion that it would be.

Q. And they desired such agreements?

A. Well, they had never suggested them to us, no. Frankly, we did it to stimulate our business.

Q. Let me ask you this, Mr. Hayden, and perhaps this is hypothetical, Counsel, for the Petitioner, you might listen, but, if all the trailer notes that you'd purchase from Baird Trailer Sales, if Baird Trailer Sales could go to the purchasers of the trailers and give them the amount of money to pay off these notes, say, he borrows from another bank and puts up maybe his building as security, in that case, when the notes were all paid off, you would have returned the entire dealer reserves to Baird Trailer Sales?

Mr. Ponder: Your Honor, I would think that that question is speculative. I don't believe there has been laid any foundation for it, it could be no more, it seems to me, than a matter of opinion, on the part of the witness, and I don't [fol. 84] see how it would go to advance the record.

The Court: I think the witness has testified as on individual, where it was paid off, now he's asking if they were all paid off.

Mr. Ponder: Excuse me, I think when he testified to one item being paid off, perhaps I'm wrong, it was in the question, to the June, '54 letter to the customer paying off the note, although perhaps not. As I read that exhibit. Now, it could apply perhaps to the dealer also. In other words, I realize that one question did go to that point, but as I say, it seems to me as a matter only of speculation, so I do feel that we have to object to the question.

The Court: I'm going to overrule your objection.

The Witness: Can I see if I have your question correct now? The problem you put to me, was, if all of Mr. Baird's contingent liability was liquidated, in other words—

By Mr. Johnson:

Q. I referred to it as the unpaid balance on the trailer notes.

A. In other words, he had no paper left with us, would we then release his reserve? The answer is, in our company, if at the same time his floor plan was, in other words, he had

no floor plan liability with him, either, we would release his reserves, yes, sir. Did I—

Q. Now, that's why I asked the question, Mr. Hayden. Actually if all those notes were paid out, if you got a separate agreement, that would require the holding of the reserve until the floor plan was paid out. Do you have a separate reserve?

A. No, sir.

Q. I mean a separate contract?

A. No, sir, we do not. It's a hard question to answer because, in a way, it's—in other words, if a person would [fol. 85] completely liquidate their business with you, you wouldn't liquidate your outstandings unless he also liquidated his floor plan, because no finance plan wants floor planning or wholesale, if they don't gain the retail business off it. It isn't profitable, so in other words, if the whole thing was liquidated, the retail and the wholesale, then we would release our reserves.

Q. Well then there is no other agreement, other than what you have in your hands and that portion which is stipulated in the stipulation of facts, that pertains to the holding of these reserves?

A. To my knowledge, no, sir.

Q. From June 10th, 1952, and thereafter, when, if all the notes were paid out, these dealer reserves would be paid back to Baird Trailer Sales, no matter what the floor plan still in effect was, isn't that true?

A. You're asking me the same question. In other words, the same question again? I don't know how to phrase what I'm saying, is our policy, if we were completely liquidated or bought out by—in other words, our outstandings were purchased away from us, at that time, we would request that our floor plan liability with whatever dealer that was, would also be purchased away from us and as soon as it was, we would release our reserves.

Q. All right. But do you have a contract in regard to that floor plan, other than is set forth in this 15-O, 16-P, and finally, 18-R, the three letters that you have in your hand, do you have a separate contract? In regard to the floor plan.

A. To my knowledge, no, sir.

Q. And you have no oral agreement that you made with Baird Trailer Sales, or in this case, with Mr. Clifton Baird, representing Baird Trailer Sales?

A. No, sir. The question never came up.

* * * * * * * *

[fol. 87]

IN THE UNITED STATES COURT OF APPEALS

For the Seventh Circuit

No. 12230

September Term, 1957

April Session, 1958

CLIFTON E. BAIRD and VIOLET L. BAIRD, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Petition for Review of Decisions of the Tax Court of the United States

Before SCHNACKENBERG and PARKINSON, Circuit Judges, and PLATT, District Judge.

OPINION—June 20, 1958

SCHNACKENBERG, Circuit Judge. Clifton E. Baird and Violet L. Baird, husband and wife, filed a petition for review of decisions of the Tax Court of the United States in a proceeding initiated by petitions filed by them in that court. Evidence consisting of exhibits and testimony was received by the Tax Court, which entered findings of fact and filed an opinion[1] The decisions now under attack determined income tax deficiencies for the years 1952,

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[1] Tax Court Memo. No. 192 (1957).

1953 and 1954, in the amounts of $16,499.72, $23,806.16, and $7,434.72, respectively.

The facts as stipulated by the parties and as found by the Tax Court may be summarized as follows:

[fol. 88] Taxpayers are husband and wife residing in Salem, Indiana. They filed joint returns on a *cash* basis for the calendar years involved with the district director of Internal Revenue for the District of Indiana. They are equal partners, doing business under the name Baird Trailer Sales. The partnership has engaged since its organization in January, 1947, in the sale of new and used mobile homes, or house-trailers, and to a lesser extent in new and used cars, parts and accessories, furniture, and real estate, in Salem, Indiana.

Partnership returns were filed for the fiscal years ended February 28, 1952, 1953, and 1954, and an amended return for the fiscal year ended February 28, 1952. The partnership kept its books and filed its income tax returns on an *accrual method* of accounting. The partnership books reflect the following gross sales and costs of sales for the relevant years:

	1952	1953	1954
Gross sales	$1,025,943.89	$1,337,385.64	$1,067,144.18
Cost of sales	859,746.75	1,141,308.59	908,027.87

During that period the partnership sold to either of two finance companies or a bank unpaid notes, chattel mortgages and conditional sales contracts. The proceeds of such sales were paid by the finance companies to the partnership, with this exception: a part was withheld by each finance company and credited to the dealer's reserve account of the partnership on the finance company's books.

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[2] The stipulation included, *inter alia*, certain testimony in a prior case of *Blaine and Evelyn K. Johnson*, No. 52306, in the Tax Court.

[3] Herein sometimes referred to as the "relevant years".

[4] All sometimes referred to herein as "finance companies".

[5] Herein sometimes referred to as "retail paper".

[6] The part withheld by the bank was deposited in an account designated "dealer escrow account" in the name of the partnership.

The partnership either endorsed with recourse retail paper sold to the finance companies or guaranteed its payment. It was agreed between the partnership and the finance companies:

(a) In the event the retail paper became due and unpaid, the finance company could charge the dealer's reserve with the unpaid balance;

[fol. 89] (b) In the event the partnership had a matured financial obligation of any nature to the finance companies,[a] the amount of such obligation could be charged to the dealer's reserve account;

(c) Repossession losses of the finance companies[a] could be charged to the dealer's reserve account;

(d) The ultimate balance in the dealer's reserve account after payment of all notes by the partnership to the finance companies[a] was to be paid to the partnership; and

(e) Each finance company could look to the balance in the dealer's reserve account to satisfy any default by the partnership on its guaranties and obligations to the finance company, as well as any default by the makers of the notes.

The partnership was not required by any finance company to do business with it to the exclusion of any other company.

The partnership was not financially able to carry the contracts of sale or the floor plan and carry the inventory of trailers held for sale, but relied upon the finance companies. For its own convenience, it procured and used in its sales legal forms furnished by the finance companies.

The account on each finance company's books designated "dealer's reserve" for the partnership was reflected as a liability of the finance company and the annual balances in such account were not reflected in its income.

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[a] The word "companies" appears in the stipulation from which the quoted paragraphs are taken.

During the relevant years, the partnership (by way of illustration) recorded the sale of a trailer and the sale of the retail paper on its books and records as follows:

Sales Receipt Journal Entry		
Cash and/or Trade-in Allowance	$1,745.00	
Contracts Receivable-Finance Company	3,800.00	
Trailer Sales		$5,545.00

[fol. 90] When the finance company remitted to the partnership, the following entry was made:

Reserve-Finance Company	$ 190.00	
Cash	3,632.67	
Expense for Intangible Stamps	1.38	
Contracts Receivable		$3,800.00
Expenses (Credit Check)		24.05
Cost of Sales		$3,824.05
Cost of Sales	$3,824.05	
Credit Inventory		$3,824.05

When a purchaser defaulted on his contract and note, the trailer was repossessed upon receipt of notice of default. The partnership always paid the finance company the unpaid balance due on such note and recorded such payment on its books and tax returns as a purchase. Where defaults occurred on the notes payable to the partnership, the payments made to the finance companies as a result of the defaults were included on the partnership's returns for the relevant years as a part of cost of goods sold. On resale of the repossessed trailer, the receipts therefrom were reported as gross receipts.

[7] For example, if a trailer costing $5,545 with notes payable outstanding of $3,500 was repossessed and the trailer's fair market value was only $3,000, the loss, if any, was reflected on the partnership's books and records as part of cost of goods as follows: The bookkeeper of the partnership either on the date of repossession or at the close of the fiscal year charged $500 to overallowance on trailers and recorded the purchase price of the trailer in cost of

from the partnership, and credited to reserve accounts in its name on the finance companies' books were includible in the taxpayers' gross income for income tax purposes in the years withheld and credited. Since the partnership was on the accrual basis, the entire profit to it from the sale of trailers and automobiles was properly includible in taxpayers' gross income at the time of sale, even though some deferred payments would not be received until a subsequent period and even though there was a possibility that the purchasers would default. He concluded that the partnership's practice of accruing less than the entire sales price is inconsistent with the accrual method of accounting.

At the outset we consider what amounts to a plea for sympathy and equitable relief made by taxpayers:

> "It is obvious that the high risk element in the sale of house trailers severely limited the market for trailer coach paper and gave heavy bargaining leverage to [fol. 93] financing institutions. As a result, the finance companies have come to exercise considerable control over a dealer's business practices and frequently participate in and police a dealer's sales.
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> * * * * * * * *
>
> "The general uncertainty of the partnership in its relationship with the finance companies is also illustrated by the fact that the sale of contracts and notes took place only because the partnership was in pressing need of funds. * * *
>
> "It is obvious that the partnership would have been much more profitable if it had been able to retain the notes and contracts received from the purchasers of its trailers. If it had been able to go forward in this fashion, it could have then realized not only the profit on the sale of the trailer, but the not inconsiderable amounts which flowed from the finance charges and other 'extras.' If the partnership had been able to hold its own paper and had not been required to discount it with the finance companies, it could have reaped the financial harvest which the finance companies were able to obtain.
>
> * * * * * * * *

> "The basic agreements disclose that the partnership was at the mercy of the finance companies in the arrangements which are involved in the instant cases. The contingencies on payments to the partnership were created by the finance companies for their protection, not by the partnership."

While we admire the courage of those who, without sufficient capital, enter into a competitive business field, where (it is asserted) risks are high and many,[8] we are aware that such an entry is voluntary and we know of no power which courts have to grant relief from the burden of income tax laws to persons who thus find themselves "at the mercy of the finance companies". Congress has power to lay and [fol. 94] collect income taxes.[9] If the application of the income tax law to persons situated as taxpayers say they were, requires special consideration, it is for Congress to say so, not us. Our duty is to ascertain what the law is and apply it to this case.

We may well start with *Spring City Co.* v. *Commissioner*, 292 U.S. 182, which affirmed this court, 67 F.2d 385. At 184, the Chief Justice said:

> "* * * Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. When a merchandising concern makes sales, its inventory is reduced and a claim for the purchase price arises. * * *"

[8] This assertion by taxpayers is refuted by the record, which shows that for the relevant years no delinquencies were charged to the dealer's reserve accounts by any finance company, and further that during said years the total deductions by the partnership for bad debts, *only a part of which were advances by the partnership to meet defaults in payment by purchasers*, amounted to only $1,203.75, $2,239.12 and $1,203.69. As hereinbefore shown, the gross sales for the same years were each well over one million dollars.

[9] Amendment XVI of the Constitution of the United States.

In a layman's language, an accrual method means that you report income when earned, even if not received, and deduct expenses when incurred, even if not paid, within the taxable period.

In the case at bar, the partnership, in a typical case, completed the transaction of the sale of a trailer at the time the down payment was made, either in cash or trade-in allowance, or both, and the purchaser executed and delivered to it notes and a chattel mortgage or conditional sales contract. The partnership thus acquired a complete enforcible right to receive the remainder of the purchase price at the times specified in the retail paper. The circumstance that the partnership was or was not financially able to retain the paper and collect it as it became due does not preclude the fact that its entire profit on the transaction *accrued* at that time regardless of when received. Therefore, no portion of the profit is rendered nontaxable at that time by the subsequent act of the partnership in selling the retail paper to a finance company in a transaction which left a part of the sales price of the paper temporarily retained as security by the finance company. It is significant and consistent with the law that the finance companies did not take into income the amounts credited on their books to [fol. 95] the partnership in the dealer's reserve accounts.

Ultimately only two things could happen to the funds in the dealer's reserve accounts: either the amounts would be paid to the partnership in cash or they would be used to satisfy the partnership's other obligations to the finance companies. There is no showing that the amounts in the reserve would not be collectible from the finance companies at the appropriate time or that their collection would be improbable, for the companies were in sound financial condition and at all times able to pay out the amounts withheld in the reserves. The only thing which would prevent the partnership from receiving the full sales price would be a purchaser's default, which is not a contingency sufficient to defer the accruing of income that has already been earned. If the partnership eventually sustains such a loss, it is recognized that it would be entitled to a business deduction therefor, because it would

be a debt, or portion thereof, arising from sales that had been included in income, and which was thereafter ascertained to be worthless. Actually the partnership elected, on its returns for the relevant years to use the bad debt deduction method, when it deducted for those years the amounts hereinbefore referred to. Significantly these amounts consisted, in part, of advances made by the partnership to the finance companies to meet trailer purchaser's payments which the purchaser was unable to make and, after advancement, the purchaser defaulted.

Taxpayers do not seek to take advantage of 26 U.S.C.A. 23 (k) (1) of the 1939 Internal Revenue Code, insofar as a deduction, in the computation of net income, is allowed ("in the discretion of the Commissioner") for a reasonable addition to a reserve for bad debts. This position taxpayers are forced to take because of their contention that the withheld part of the sale price did not accrue to them during the relevant years. However, quite inconsistently with their argument that the withheld amounts were not accrued income to the partnership, the latter did claim, as deductions, debts included in said accounts which defaulted within the relevant years. As the court said in *Rogan* v. *Commercial Discount Co.*, 149 F.2d 585,[10] at 586:

> [fol. 96] "At all times pertinent to this inquiry, the taxpayer was operating under the reserve method for handling bad debts and did not employ the charge-off method. The statute allows these alternative methods, but having made an election as to which method it would adopt, it could not change to the other method in the absence of the Commissioner's express permission. * * * "

It is, therefore, apparent that, although § 23 (k) (1) permits the deduction of *either*, first, specific debts which become worthless within the taxable year or, secondly, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts, the partnership chose to use the specific debt charge-off method for bad debts, and

[10] Cert. denied, 326 U.S. 764.

should not be allowed any deductions as a reserve for bad debts.

In *Universal Oil Products Co.* v. *Campbell*, 181 F.2d 451, (cert. denied, 340 U.S. 850, rehearing denied, 340 U.S. 894) at 470, we said:

> "Vague possibilities that income may have to be returned, or that it may possibly be subject to diminution or off-set will not alone suffice to postpone the accrual and reporting of taxable income. * * *"

We then referred to *Helvering* v. *Nibley-Mimnaugh Lumber Company*, 63 App. D.C. 181, 70 F.2d 843, where a contract for sale of timberland was executed in 1923 and it was provided that part of the purchase price was paid in cash and the balance thereof by promissory notes secured by a mortgage. The contract further provided that taxpayer should furnish abstracts and that, for certain contingencies as to failures of title and as to there being a smaller amount of timberland than specified in the contract, there should be a reduction in the purchase price. Such reductions, if any, were to be applied against the principal of the notes. We said, at 471 of the *Universal Oil* case:

> "* * * By reason of a shortage in the timberland, determined in 1924, it was agreed between the parties that more than $66,000 of the stated sale price should be deducted from the notes representing the balance of the purchase price. The Court held that if the [fol. 97] taxpayer was reporting and paying taxes on an accrual basis, the facts shown were sufficient to accrue the entire purchase price in 1923, even though the agreed price was conditionally subject to abatement. The Court said that the right of the seller to have the notes paid, accrued in 1923, because it then became a fixed and unconditioned liability. It is significant that in that case there was, as here, a condition which provided for a proportionate reduction in the purchase price in the event of the happening of a certain contingency."

Our conclusions, therefore, were:

> "We see from these decisions that it is not every contingency that prevents the accrual of income. The contingency must be real and substantial. * * *
>
> * * * * * * *
>
> "* * * We must, therefore, hold that it was the duty of plaintiff to accrue and report as a part of its 1945 income the total amount of $1,035,205, which it was to receive as its share of the consideration for the license."

To the same effect are *Commissioner of Internal Revenue* v. *Union Pac. R. Co.*, 86 F.2d 637, 639; *Frost Lumber Industries* v. *Commissioner of Int. Rev.*, 128 F.2d 693, 696; and *Clark* v. *Woodward Construction Co.*, 179 F.2d 176, where the court, at 177, said: "The decisive factor is the creation of an enforceable liability."

In the case at bar, each sale was a transaction solely between the purchaser and the partnership. They agreed on the terms of sale, including the selling price, the down payment, the trade-in allowance, and the terms for deferred payments. The purchaser made his down payment to the partnership and delivered his traded-in vehicle to it, together with the executed retail papers. The purchaser went his way and the partnership kept the down payment and the traded-in vehicle. It was the decision of the partnership as to which finance company it would offer the retail paper. It had complete freedom of choice in this regard and conversely each finance company was free to take or refuse the offered paper. Transfer of the paper to a finance company resulted in the partnership receiving the balance of the purchase price, minus the withheld portion, the year [fol. 98] of taxability of which is now the subject of this litigation. When this reserve had served its purpose, the partnership would also receive what remained in that fund.

Since the partnership used the accrual method of accounting, its entire profit from the sale should be reported when it accrued, regardless of when received.

Taxpayers contend that the partnership's "right to the amounts withheld from the purchase price of notes was so contingent during the taxable period that such amounts

should not be accrued as taxable income in the years withheld by the finance companies." While it is possible that the partnership would not receive all of the amounts in cash, the parts withheld would in all events be used for the benefit of the partnership to satisfy its future obligations, if any, to the finance companies. Taxpayers confuse the arrangement with respect to *payment* of the sums in the reserve accounts with the vesting in the partnership in the relevant years of a fixed right to receive in due course definite sums which had become accruable to it at the times of sale in the relevant years. There is no uncertainty with respect to the amounts accrued during the relevant years. These amounts were definitely fixed at the time the funds were placed to the partnership's credit in the dealer's reserve accounts. Moreover, there is no showing that the amounts in the reserve accounts would not be collectible at the appropriate time or that collection would be improbable, as we have pointed out, *ante* 5.* In the light of the record, it cannot logically be argued that the reserve would never be realized by the partnership.

In its reply brief, the partnership, for the first time, argues that it could have obtained the benefits of reporting its income under the installment method, if it had been financially able to hold the retail paper instead of selling it to finance companies. Evidently referring to 26 U.S.C.A. § 44 (a), it argues that an accrual basis taxpayer is entitled to report his installment sale profit in the taxable years that payments are actually received. However, there is no showing by taxpayers that the partnership purported, in making its returns of income, to rely on § 44(a). Apparently the argument comes as an afterthought. It is not convincing.

[fol. 99] Taxpayers have also called our attention to *Johnson* v. *Commissioner*, 233 F.2d 952, *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F.2d 395, and *Glover* v. *Commissioner*, 253 F.2d 735. Even if we ignore some of the facts involved in these cases, which are different from those involved in the case at bar, we adhere to the views herein expressed.

We affirm the decisions of the Tax Court.

Affirmed.

* Printed herein at page 78.

[fol. 101]

IN UNITED STATES COURT OF APPEALS
For the Seventh Circuit

Before HON. ELMER J. SCHNACKENBERG, Circuit Judge, HON. W. LYNN PARKINSON, Circuit Judge, HON. CASPER PLAYY, District Judge.

CLIFTON E. BAIRD, and VIOLET L. BAIRD, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

No. 12230

Petition for Review of Decisions of the Tax Court of the United States

JUDGMENT—June 20, 1958

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the Tax Court of the United States entered in this cause on October 11, 1957, be, and the same are hereby, Affirmed.

[fol. 102] Clerk's Certificates to foregoing transcript (omitted in printing).

[fol. 104]

SUPREME COURT OF THE UNITED STATES

No. 512, October Term, 1958

CLIFTON E. BAIRD and VIOLET L. BAIRD, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE.

ORDER EXTENDING TIME TO FILE PETITION FOR WRIT OF CERTIORARI—September 17, 1958

Upon Consideration of the application of counsel for petitioner(s),

It Is Ordered that the time for filing petition for writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including

Nov 17, 1958.

/s/ Tom C. Clark, Associate Justice of the Supreme Court of the United States.

Dated this 17th day of September, 1958.

[fol. 106]

SUPREME COURT OF THE UNITED STATES

No. 512, October Term, 1958

CLIFTON E. BAIRD and VIOLET L. BAIRD, Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE.

ORDER ALLOWING CERTIORARI—December 15, 1958

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Seventh Circuit

is granted. The case is transferred to the summary calendar and assigned for argument immediately following No. 381.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Frankfurter took no part in the consideration or decision of this application.

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No. 380

Office-Supreme Court, U.S.
FILED
SEP 18 1958
JAMES R. BROWNING, Clerk

In the Supreme Court of the United States

OCTOBER TERM, 1958

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

JOHN R. HANSEN AND SHIRLEY G. HANSEN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1958

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

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JOHN R. HANSEN AND SHIRLEY G. HANSEN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 65-68) is not officially reported. The opinion of the Court of Appeals (Appendix A, *infra*, pp. 9-20) is not yet reported.

JURISDICTION

The judgment of the Court of Appeals was entered on August 4, 1958. (Appendix A, *infra*, p. 20.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether an accrual-basis taxpayer who sells property and receives part of his gain on the sale in cash and part in the form of a credit—the latter portion to be ultimately satisfied either by payment in cash or by offset against the taxpayer's obligations—is required to report the amount of gain so credited (as well as the gain in cash) as income for the year in which the credit is made.

STATUTE AND OTHER AUTHORITY INVOLVED

The statutory provisions involved are Sections 22(a), 41, and 42 of the Internal Revenue Code of 1939. Those sections, together with Rev. Rul. 57-2, 1957-1 Int. Rev. Bull. 17, are set forth in Appendix B, *infra*, pp. 21-25.

STATEMENT

During 1951, 1952, and 1953, taxpayer John R. Hansen was engaged in the business of selling automobiles at retail, under conditional sales contracts providing for payment of the purchase price in installments. The form of contract used, which was provided by the General Motors Acceptance Corporation (GMAC), called for a "Total Time Price" for the automobile sold, computed by subtracting the down payment (including the trade-in, if any) from the "Cash Sale Delivered Price", and adding to the difference the cost of insurance and finance charges. The amount thus arrived at was called the "Time (Deferred) Balance." The down payment was added back to the "Time (Deferred) Balance" to fix the "Total Time Price." (R. 61.)

Taxpayer financed all of the conditional sales during the taxable years through GMAC. He assigned each

contract pursuant to the terms of the endorsement contained thereon,[1] in exchange for the amount set forth in the contract, but reduced by an amount withheld and placed by GMAC in a reserve account. Taxpayer was not required to assign any of the contracts to GMAC or to any other finance company, and could have held such contracts himself without assignment. (R. 63.)

Under the reserve account maintained between taxpayer and GMAC, at least 5% of the outstanding balances of the contracts assigned to GMAC were retained

[1] The form contract included the following endorsement, executed by taxpayer upon assignment (Stip. Ex. 5-E; R. 6, 39-40, 62-63):

> For value received, undersigned does hereby sell, assign and transfer to the General Motors Acceptance Corporation his, its or their right, title and interest in and to the within contract, herewith submitted for purchase by it, and the property covered thereby and authorizes said General Motors Acceptance Corporation to do every act and thing necessary to collect and discharge the same.
>
> The undersigned certifies that said contract arose from the sale of the within described property, warranting that title to said property was at time of sale and is now vested in the undersigned free of all liens and encumbrances; that said property is as represented to the purchaser of said property by the undersigned and that statements made by the purchaser of said property on the statement form attached hereto are true to the best of the knowledge and belief of the undersigned.
>
> In consideration of your purchase of the within contract, undersigned guarantees payment of the full amount remaining unpaid hereon, and covenants if default be made in payment of any instalment herein to pay the full amount then unpaid to General Motors Acceptance Corporation upon demand, except as otherwise provided by the terms of the present General Motors Acceptance Corporation Retail Plan. Liability of the undersigned shall not be affected by any indulgence, compromise, settlement, extensions or variation of terms of the within contract effected with, or by the discharge or release of the obligation of the purchaser or any other person interested, by operation of law or otherwise. Undersigned waives notice of acceptance of this guaranty and notices of non-payment and non-performance.

by it. The reserve was maintained in order to protect GMAC against any loss arising from the repossession of automobiles in the event of default in payment. Also, in the event of prepayments by the purchasers of automobiles, the proportionate reduction in finance charges was charged to the reserve. (R. 63-64.)

Taxpayer's books of account and income tax returns were maintained and filed on the accrual method of accounting. In reporting income and maintaining his accounts, taxpayer debited the amounts placed in the reserve to an account entitled "Due Finance Company", and credited an account entitled "Reserve for Repossession." He did not report, in his income tax returns for 1951 and 1953, any of the amounts which were withheld by GMAC in the reserve account.[2] He did report the amounts retained in the reserve account as income in the years when such amounts were paid to him by GMAC. (R. 64.)

The Tax Court sustained the Commissioner's deficiency determination, holding that the amounts credited to the dealer's reserve account were accruable as income in the years in which they were credited to that account. (R. 64-65.) The Court of Appeals reversed the Tax Court's decision with respect to that issue. (Appendix A, *infra*.)

REASONS FOR GRANTING THE WRIT

1. The decision below, which involves an important issue as to the accruability of income for tax purposes, is in direct conflict with the decision of the Sixth

[2] Taxpayer did report, in his 1952 return, the amount of $4,462.27 which was withheld by GMAC in the reserve account. He included the same amount in 1953 income, necessitating an adjustment of income for that year. (R. 72.)

Circuit in *Schaeffer* v. *Commissioner*, decided August 20, 1958 (Appendix C, *infra*, pp. 26-34), and of the Seventh Circuit in *Baird* v. *Commissioner*, decided June 20, 1958 (1 A.F.T.R. 2d 58-2014) (Appendix C, *infra*, pp. 35-49).[3] There are no material factual differences in the cases, and the issue posed in all three is precisely the same.

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[3] The Fourth, Fifth and Eighth Circuits are in accord with the decision below. See *Johnson* v. *Commissioner*, 233 F. 2d 952 (C.A. 4th); *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395 (C.A. 5th); and *Glover* v. *Commissioner*, 253 F. 2d 735 (C.A. 8th), in which the Government is also filing a petition for certiorari.

The Tax Court, over a period of seventeen years, has regularly sustained the Commissioner's position. *Shoemaker-Nash, Inc.* v. *Commissioner*, 41 B.T.A. 417; *Colorado Motor Car Co.* v. *Commissioner*, decided March 25, 1940 (1940 P-H B.T.A. Memorandum Decisions, par. 40,178); *Royal Motors, Inc.* v. *Commissioner*, decided July 12, 1945 (1945 P-H T.C. Memorandum Decisions, par. 45,255; *Town Motors, Inc.* v. *Commissioner*, decided July 24, 1946 (1946 P-H T.C. Memorandum Decisions, par. 46,173); *Ray Woods Used Cars, Inc.* v. *Commissioner*, decided September 30, 1952 (1952 P-H T.C. Memorandum Decisions, par. 52,290); *Central Motors, Inc.* v. *Commissioner*, decided August 12, 1954 (1954 P-H T.C. Memorandum Decisions, par. 54,228); *Blaine Johnson* v. *Commissioner*, 25 T.C. 123, reversed, 233 F. 2d 952 (C.A. 4th); *Wm. Koch Motors, Inc.* v. *Commissioner*, decided December 30, 1955 (1955 P-H T.C. Memorandum Decisions, par. 55,334); *Brodsky* v. *Commissioner*, 27 T.C. 216; *Texas Trailercoach, Inc.* v. *Commissioner*, 27 T.C. 575, reversed, 251 F. 2d 395 (C.A. 5th); *West Pontiac, Inc.* v. *Commissioner*, 27 T.C. 749, reversed, February 6, 1958 (C.A. 5th) (1 A.F.T.R. 2d 58-839); *Glover* v. *Commissioner*, decided March 18, 1957 (1957 P-H Memorandum Decisions, par. 57,045), reversed, 253 F. 2d 735 (C.A. 8th); *Schaeffer* v. *Commissioner*, decided April 30, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,068), affirmed August 20, 1958 (C.A. 6th) (Appendix C, *infra*, pp. 26-34); *Baird* v. *Commissioner*, decided October 9, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,192), affirmed June 20, 1958 (C.A. 7th) (1 A.F.T.R. 2d 58-2014) (Appendix C, *infra*, pp. 35-49); *Kilborn* v. *Commissioner*, 29 T.C. 102, pending on appeal to the Fifth Circuit; *Arthur V. Morgan* v. *Commissioner*, 29 T.C. 63, now pending on appeal to the Ninth Circuit; *Evans Motor Co.* v. *Commissioner*, 29 T.C. 555.

Although the decision below ostensibly rests upon an analysis of each automobile sale and financing arrangement as involving one indivisible transaction—whereas the decisions in *Schaeffer* and *Baird* recognize that, under the rationale of this Court's decision in *Raybestos-Manhattan Co.* v. *United States*, 296 U.S. 60, there are really two separable, although practically simultaneous, transfers—the conflict is not thereby obviated since the transactions involved in all three cases were plainly of the same kind. Moreover, the decisions in *Schaeffer* and *Baird* appear to accept the Government's position that, whichever analysis is adopted, the result for tax purposes should be the same under accepted principles of accrual accounting.

Nor does characterization of the instant taxpayer's right to the amounts in the dealer's reserve account as "so remote and contingent that it cannot be said to have become fixed and ascertained" (Appendix A, *infra*, p. 15) detract from the conflict with *Schaeffer* and *Baird*, since it is clear that in all three cases the taxpayers would eventually receive the amounts in the reserve accounts, either in cash or in the discharge of their respective obligations to the finance companies.

2. The necessary effect of the decision below is to permit a taxpayer, having a fixed right to income which is credited to him and which he will ultimately receive either in cash or by offset against his obligations, to avoid the reporting of the income in the year in which it is credited to him, despite the fact that he is on the accrual basis of accounting. This cannot be squared with the settled principle, stated by this Court in *Spring City Co.* v. *Commissioner*, 292 U.S. 182, 184-185, "that it is the *right* to receive and not the actual receipt

that determines the inclusion of the amount in gross income", and that "[w]hen the right to receive an amount becomes fixed, the right accrues". See, also, *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 423; *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. 290, 295.

It is of substantial importance to the revenue that this concept of accruability be preserved.[4] As the Court of Appeals for the Seventh Circuit has stated, if there is to be any "special consideration" for business enterprises allegedly "at the mercy of the finance companies", "it is for Congress to say so," not the courts. *Baird* v. *Commissioner*, decided June 20, 1958 (1 A.F.T.R. 2d 58-2014), Appendix C, *infra*, pp. 35-49. See, also *Schaeffer* v. *Commissioner* (C.A. 6th), decided August 20, 1958, Appendix C, *infra*, pp. 26-34. But cf. *Glover* v. *Commissioner*, 253 F. 2d 735 (C.A. 8th); *Johnson* v. *Commissioner*, 233 F. 2d 952 (C.A. 4th); *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395 (C.A. 5th).

Resolution of the question presented is also important to the many taxpayers, in every part of the country, who are engaged in installment or conditional sales operations involving the same type of financing as in the instant case, and who, in the absence of a definitive ruling by this Court, will report income on different bases, depending on the jurisdiction in which the tax return is filed. Obviously, this inequality should be eliminated.

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[4] Putting aside the many related situations, the amounts involved in automobile dealer "reserve" cases are, themselves, very substantial, both currently and potentially.

CONCLUSION

There is a direct conflict among the circuits and the question involved is one of substantial importance in the administration of the revenue laws. This petition for a writ of certiorari should be granted.

Respectfully submitted,

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SEPTEMBER, 1958.

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 15,821

JOHN R. HANSEN AND SHIRLEY G. HANSEN, PETITIONERS,

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Aug. 4, 1958

Petition to Review a Decision of the Tax Court of the United States

Before: POPE, BARNES and HAMLEY, Circuit Judges

BARNES, Circuit Judge:

Taxpayers, husband and wife, have petitioned for review of a memorandum decision of the Tax Court sustaining deficiencies in income taxes for the years 1951, 1952, and 1953 and imposing penalties for failure to file estimated returns and for substantial underestimation of taxes for those years.

John R. Hansen (hereinafter referred to as petitioner) was, in the years in question, engaged in the business of selling new automobiles. It is stipulated that all such sales were financed by the General Motors Acceptance Corporation (GMAC). As a part of the normal course of dealing, and apparently pursuant to a GMAC "Retail Plan" referred to at the trial, GMAC paid Hansen 95% of the sales price of the car at the time of the sale and retained in a dealer reserve account the remaining 5%. GMAC also credited to that account a certain percentage of the financing charges as payments from the purchaser were received. Under

this arrangement no portion of the 5% reserve account was payable to Hansen except at the complete discretion of GMAC; and release of any funds was contingent on there being in the reserve account an amount in excess of 5% of all outstanding contracts. Petitioner, an accrual basis taxpayer, returned as income in the year of sale 95% of the sales price of each automobile sold. He did not accrue and return as income the GMAC reserves in the year of sale—the year they were established. His books reflected an asset account "Due Finance Co." and a liability account "Reserve for Repossession," but these were never taken into or deducted from income. Taxpayer used a specific charge-off account for bad debts arising from the business, but no losses on GMAC reserves were charged to this account. This bad debt account was unrelated to the credit sales financed through GMAC. Petitioner reported as income the amounts paid from these accounts in the year they were released to him by GMAC.

The Commissioner determined that the finance charge attaching to each sale was an integral part of the selling price; that the right to receive from the purchaser the full amount of the contract price was fixed in the year of sale; and that the dealer's reserve was contingent for possible losses and not a proper basis for reduction of gross income. The Tax Court sustained this determination, holding that the amount credited to the dealer's reserve was accruable into income in the year credited to the reserve account. The Tax Court also sustained the penalties for failure to file an estimated return and for substantial underestimation of taxes. From these two holdings, this petition for review was prosecuted.

I. Accruability of Dealer Reserves

The problem before us is not new to the tax law, although it is apparently one of first impression in this

Court. The Tax Court has consistently held dealer reserve accounts accruable in the year established, not in the year of actual payment to the dealer.[1] With equal consistency the Courts of Appeals and the District Courts have taken the opposite view.[2] The source of taxpayer's anguish in these cases is that a tax must be paid without the funds upon which the tax is levied being available for payment of the tax. This may often be the result of accrual accounting, just as it may be the result of operation of the doctrines of realization and constructive receipt. We are not impressed with the emphasis placed on this element of the case by those courts which have resolved the problem in favor of the taxpayer. On the other hand, the government is not being deprived of revenue in the long run. There is here no tax avoidance device. The dealer reserve amounts have always been reported as income in the year received. The only difference between the taxpayer and his government, therefore, is *when*, not whether, the amounts are taxable as income.

Certain principles are appropriate for review. A cash basis taxpayer records income upon actual or con-

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[1] *Evans Motor Co.*, 1957, 29 T.C. No. 62; *Kilborn*, 1957, 29 T.C. No. 14; *Morgan*, 1957, 29 T.C. No. 9; *West Pontiac*, 1957, 27 T.C. 749; *Texas Trailercoach*, 1956, 27 T.C. 575; *Brodsky*, 1956, 27 T.C. 216; *Blaine Johnson*, 1955, 25 T.C. 123; *Shoemaker-Nash*, 1940, 41 B.T.A. 417.

[2] *Glover* v. *Comm'r*, 8 Cir., 1958, 253 F.2d 735; *West Pontiac* v. *Comm'r*, 5 Cir., 1958, — F.2d —; *Texas Trailercoach* v. *Comm'r*, 5 Cir., 1958, 251 F.2d 395, reversing 27 T.C. 575; *Johnson* v. *Comm'r*, 4 Cir., 1956, 233 F.2d 952; *Modern Olds* v. *United States*, N.D. Tex., 1957, — F.Supp. —; *Hines Pontiac* v. *United States*, N.D. Tex., 1957, — F.Supp. —; *Massey Motors* v. *United States*, S.D. Fla., 1957, 156 F.Supp. 516; *Marine Chevrolet Co., Inc.* v. *United States*, 1958, — F.Supp. —; C.C.H. Fed. Tax. 1958, para. 9441. The issue is pending in this Circuit in *Morgan* v. *Comm'r*, #15898; in the sixth circuit in *Schaeffer* v. *Comm'r*, #13421; cf. *Keasby & Mattison* v. *United States*, 3 Cir., 1944, 141 F.2d 163. But cf. *Baird* v. *C.I.R.*, 7 Cir., decided June 20, 1958, — F.2d —.

structive receipt—and it is well to note that constructive receipt means that the taxpayer *has the present right to receive* funds which he, for his own reasons, chooses not to exercise (Treas. Reg. 118, § 39.42-2). An accrual basis taxpayer must record income, and pay tax thereon, upon *fixation* of the right to receive income, not upon its actual or constructive receipt.

> "When the right to receive an amount becomes fixed, the right accrues"[3]

With these basic concepts well in mind, we move to a consideration of the transactions here involved.

Hansen, as an automobile dealer, financed all sales exclusively through GMAC and all sales were written up on a form conditional sales contract supplied by GMAC. This contract provided for a "Total Time Price" computed, in a vastly simplified version, by adding to the cash price of the car (cost plus profit) the finance charges required by GMAC. This total time price reduced by the purchaser's down payment results in the "Time (Deferred) Balance" which becomes due and payable at the GMAC office in whatever number of installments are determined. This contract also provides, beneath the signatures of seller and purchaser, a "Dealer's Recommendation, Assignment and Guaranty," which provides, "for value received," for an immediate assignment to GMAC of the dealer's interest in the contract.

The transaction consummated and evidenced by this contract is subject to three possible interpretations. The government urges that there are here two separate sales: first, of the car by the dealer to the purchaser, giving rise to fixation of the right to receive the "Total Time Price" and requiring that amount to be accrued in the year of sale; second, of the conditional sales con-

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[3] *Spring City Co.* v. *Comm'r*, 1934, 292 U.S. 182, 184.

tract by the dealer to GMAC, for which GMAC pays less than the fair market value, but which can serve only as a basis for potential loss deductions not here pertinent.[4] We are in complete agreement with the Court in *Texas Trailercoach* v. *Comm'r*, 5 Cir., 1958, 251 F. 2d 395, that such a view is totally unrealistic. Such an artificial characterization of the transaction ignores entirely the complete integration of the financing institution that has become the hallmark of the automobile industry. It also ignores the uncontradicted evidence in the instant case showing that all sales were in fact so financed and that no sales could have been consummated without the financial assistance of GMAC.

The transaction, we believe, is properly construed as a single three-cornered arrangement involving the dealer, the purchaser, and the finance company.[5] But even so, this does not solve the problem. The transaction may still be seen as singular, while its elements are plural. It can be reasoned that the right to the sale price is fixed at the time of the contract, thereby requiring the dealer to accrue that amount, although he has actual receipt of only 95% thereof (*cf. Commissioner* v. *Cleveland Tr. Paving Co.*, 6 Cir., 1932, 62 F.2d 85.) The only amount not includable in the year of sale would then be that portion of the finance charges to which the dealer is entitled as they become fixed. (See the opinion of Black, J., in *Texas Trailercoach*, 1956, 27 T.C. 575, 580.) Although such an approach is entirely consistent with the principles of accrual accounting noted earlier, we are of the opinion that the peculiarities of automobile financing make this inter-

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[4] To infer, as does the government, that the only question here is one of deductions "seems to shut off the inquiry at the point where we would begin and raises a question . . . that is not present in the case before us." Texas Trailercoach v. Comm'r, supra, p. 397.

[5] Glover v. Comm'r, supra, note 2; Texas Trailercoach v. Comm'r, supra, note 2; Johnson v. Comm'r, supra, note 2.

pretation as unrealistic as that already rejected. We think Judge Wisdom ably and adequately stated the realities of this type of transaction in the *Texas Trailer-coach* case, *supra*, where at p. 397, after expressing the general belief that "Tax incidence should reflect the realities of a business transaction," he stated:

> "When we get down to what actually happens . . . we find one transaction, a three-cornered agreement with inter-related obligations of dealer, purchaser and finance company. Instead of being out of the first step of the transaction (the trailer sale to the purchaser), the finance company dictates the terms of the sale, has obligations running to it in the sales contract, has a fixed percentage for its finance charges worked into the sales price, and is as much a part of the substance of the business transaction as the dealer—whether or not it is the dealer who transfers the title formally to the purchaser, apparently for one hundred per cent of the purchase price. The hard core of the factual situation is that, under the three-way agreement, the dealer receives from the purchaser only a ninety-five per cent claim of right to the unpaid balance, plus a contingent claim, against the purchaser, to the remaining five per cent subject to a number of important conditions in favor of the finance company. The dealer transfers to the finance company, simultaneously, only what he receives from the purchaser. He receives from the finance company ninety-five per cent of the sales price plus a contingent claim, against the finance company, to the remaining five per cent then entirely under the dominion and control of the finance company. The dealer's claim to this five per cent may never become fixed or ascertainable; it may never be received."

At the time of the sale the only right which becomes fixed is the right to receive 95% of the sale price, and not the total time price, from the purchaser through GMAC. The amount credited to the dealer's reserve is completely controlled by GMAC. It is true an amount is fixed, but this amount is subject to unilateral depletion by GMAC to off-set repossession losses, prepayment refunds, and other charges determined by GMAC; the possibility of payment under this circumstance, although the maximum amount is determined, is so remote and contingent that it cannot be said to have become fixed and ascertained (*cf. Long Poultry Farms v. Comm'r,* 4 Cir., 1957, 249 F.2d 726, acquiesced in by the Commissioner, Rev. Rul. 57-358, 1958 P-H para. 54-503).

We have no quarrel with the theory of the Tax Court's position. Had the petitioner financed these sales himself, or elected to sell the contract as a separate transaction, the result reached below would be correct. The dealer's recourse in those situations necessarily would be limited to the reserve for loss deductions allowed under 26 U.S.C. § 166 (formerly 26 U.S.C. § 23 (k)(1)), or the installment sale provisions of 26 U.S.C. § 453(a) (formerly 26 U.S.C. § 44(a)). But that is not the factual case here presented. Petitioner had no such choices available to him. He was limited to a contract whereby he would finance through GMAC and receive only 95% of the sale price, or he had no contract at all. This being so, the portion actually paid to GMAC but earmarked for petitioner was not an amount to which his right of receipt became fixed. It became fixed only when GMAC decided it should pay out some of the funds held in the dealer's reserve.

Section 41 of the Internal Revenue Code of 1939 (now 26 U.S.C. § 446) requires net income to be determined in accordance with the taxpayer's method of accounting or by the Commissioner in accordance with

such methods as clearly reflect the income for the accounting period. A realistic view of the transactions of this petitioner confirms our conclusion that the Tax Court's re-allocation of income in accordance with the commissioner's assessment must be reversed in order to clearly reflect taxable income for the years in question.

II. Penalties

Petitioner admits that he filed no estimated returns during these years and the court below found that his failure was not due to reasonable cause. This finding is not disputed. The applicable provisions of the Internal Revenue Code of 1939 are § 294(d)(1)(A),[6] which provides a maximum 10% penalty for failure to file a declaration of estimated tax; and § 294(d)(2),[7]

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[6] "§ 294(d). Estimated tax

(1) Failure to file declaration or pay installment of estimated tax

(a) Failure to file declarations. In the case of a failure to make and file a declaration of estimated tax within the time prescribed, unless such failure is shown to the satisfaction of the Commissioner to be due to reasonable cause and not to willful neglect, there shall be added to the tax 5 per centum of each installment due but unpaid, and in addition, with respect to each such installment due but unpaid, 1 per centum of the unpaid amount thereof for each month (except the first) or fraction thereof during which such amount remains unpaid. In no event shall the aggregate addition to the tax under this subparagraph with respect to any installment due but unpaid, exceed 10 per centum of the unpaid portion of such installment. For the purposes of this subparagraph the amount and due date of each installment shall be the same as if a declaration had been filed within the time prescribed showing an estimated tax equal to the correct tax reduced by the credits under sections 32 and 35."

[7] "§ 294(d) (2) Substantial underestimate of estimated tax: If 80 per centum of the tax (determined without regard to the credits under sections 32 and 35), in the case of individuals other than farmers exercising an election under section 60(a), or 66⅔ per centum of such tax so determined in the case of such farmers, exceeds the estimated tax (increased by such

which provides a maximum 6% penalty for substantial underestimation of tax.[8]

Taxpayer argues that a logical interpretation of these sections precludes assessment of both penalties where there has been a failure to file the estimated return. His argument is that there can be no underestimate where there has been no estimate at all; and since every failure to file necessarily would be a substantial underestimation, the greater must include the lesser. This position has support in a number of cases following the decision in *United States* v. *Ridley*, N.D.Ga., 1954, 120

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credits), there shall be added to the tax an amount equal to such excess, or equal to 6 per centum of the amount by which such tax so determined exceeds the estimated tax so increased, whichever is the lesser. This paragraph shall not apply to the taxable year in which falls the death of the taxpayer, nor, under regulations prescribed by the Commissioner with the approval of the Secretary, shall it apply to the taxable year in which the taxpayer makes a timely payment of estimated tax within or before each quarter (excluding, in case the taxable year begins in 1943, any quarter beginning prior to July 1, 1943) of such year (or in the case of farmers exercising an election under section 60(a), within the last quarter) in an amount at least as great as though computed (under such regulations) on the basis of the taxpayer's status with respect to the personal exemption and credit for dependents on the date of the filing of the declaration for such taxable year (or in the case of any such farmer, or in case the fifteenth day of the third month of the taxable year occurs after July 1, on July 1 of the taxable year) but otherwise on the basis of the facts shown on his return for the preceding taxable year. 53 Stat. 88, as amended June 9, 1943, 7 p.m., E.W.T., c. 120, § 5(b), 57 Stat. 144; Feb. 25, 1944, 12:49 p.m., E.W.T., c. 63, Title I, § 118(a), 58 Stat. 37; May 29, 1944, 7 p.m., E.W.T., c. 210, Part I, §§ 6(b), (8), 13(b), 58 Stat. 235, 244."

[8] A third penalty, for failure to pay the estimated tax, was provided by § 294(d)(1)(B), but was specifically applicable only where a declaration had been filed. These three penalty provisions have now been consolidated into one 6% penalty for underpayment of estimated tax. Int. Rev. Code of 1954, § 6654.

F. Supp. 530.[9] The Courts of Appeals for the Fifth Circuit (*Patchen* v. *C.I.R.*, F.2d (July 23, 1958)), and the Third Circuit (*Abbott* v. *C.I.R.*, F.2d (July 31, 1958)), and the Tax Court, however, have taken the position that these provisions are independently applicable (see, e.g., *Fuller*, 1953, 20 T.C. 308, aff'd on other grounds, 10 Cir., 1954, 213 F.2d 102), and other District Courts have similarly decided: *Palmisano* v. *United States*, E.D. La., 1958, 159 F. Supp. 98; *Farrow* v. *United States*, S. D. Cal., 1957, 150 F. Supp. 581; *Erwin* v. *Granquist*, D. Ore., 1957, aff'd on other grounds, 9 Cir., 1958, 253 F.2d 26, cert. denied, May 19, 1958.[10]

Were we compelled to base our decision on logic alone, we are by no means convinced that it is not as logical to read the two code sections as imposing cumulative penalties as one. However, Congress has on two occasions expressed its intention that both these penalty provisions are applicable to a taxpayer who has failed to file a declaration of estimated tax. The Senate and conference reports on the original bill containing these provisions (57 Stat. 126) contain the following language:

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[9] Accord, *Acker* v. *C.I.R.*, 6 Cir., 1958, —— F.2d ——; *Barnwell* v. *United States*, E.D.S.C., 1958, —— F.Supp. ——; *Jones* v. *Wood*, D. Ariz., 1957, 151 F.Supp. 678; *Stenzel* v. *United States*, N.D. Cal., 1957, 150 F.Supp. 634; *Powell* v. *Granquist*, D. Ore., 1956, 146 F. Supp. 308, aff'd on other grounds, 9 Cir., 1958, 252 F.2d 56; *Owen* v. *United States*, D. Neb., 1955, 134 F. Supp. 31; *Witt* v. *Tomlinson*, S.D. Fla., 1958 —— F.Supp. ——, P-H Current Decisions 58-1350; *Glass* v. *Dunn*, P-H Fed. Tax, 1956, para. 73,100.

[10] Accord, *Abbott*, 1957, 28 T.C. 798, aff'd, 3 Cir., 1958, —— F.2d ——; *Beacham*, 1957, 28 T.C. 598, aff'd, *Beacham* v. *C.I.R.*, 5 Cir., 1958, 255 F.2d 103; *Kaltreider*, 1957, 28 T.C. 121; *Patchen*, 1956, 27 T.C. 592, aff'd, *Patchen* v. *C.I.R.*, 5 Cir., —— F.2d —— (July 23, 1958); *Acker*, 1956, 26 T.C. 107, rev'd, *Acker* v. *C.I.R.*, 6 Cir., —— F.2d —— (June 18, 1958). *Cf. Prokop* v. *C.I.R.*, 7 Cir., 1958, 254 F.2d 544.

> "In the event of a failure to file a declaration where one is due, the amount of the estimated tax for the purposes of this provision (§ 294(d)(2)) *will be zero.*"[11]

Thus it is abundantly clear that Congress was aware of the difficulty in measuring the underestimation penalty where no estimate was filed and pursuant to this understanding indicated that in the event of a failure to file, the amount of the estimated tax would be presumed to be zero. No other conclusion is possible but that Congress intended § 294(d)(2) penalties even in a situation giving rise to § 294(d)(1)(A) penalties, that is, a failure to file is also a substantial underestimation of taxes due. Subsequent amendments to these provisions changed the amounts of the penalties, but in no way altered their substantive effect.

In the 1954 revision of the Internal Revenue Code, Congress recognized the double-barreled operation of these statutes in stating:

> "This charge (for underestimation) and the charge for failure to file a declaration or pay an installment of estimated tax may run concurrently and result in a combined charge of 15 (sic) percent of the estimated tax due."[12]

And the more lenient provisions of the present 26 U.S.C. § 6654 resulted. Thus at the time Congress changed the law, it recognized what the law then was.

We conclude from these expressions of congressional intent that where a taxpayer fails to file a declaration of estimated tax he was formerly, and during the years here involved, liable for the penalties imposed by § 294

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[11] S. Rep. No. 22, 1943 Cum. Bull. 1314, 1345; Conf. Rep. No. 510, 1943 Cum. Bull. 1351, 1372. (Emphasis added.)

[12] H. Rep. No. 1337, 3 U.S.C. Cong. & Adm. News 4017, 4127 (1954).

(d)(2) as well as for those imposed by § 294(d)(1)(A). In this respect the decision of the Tax Court is affirmed.

The judgment is affirmed as to the penalties assessed, but as to the imposition of tax on the dealer reserves the judgment is reversed and remanded for recomputation and entry of judgment in accordance with this opinion.

(Endorsed:) Opinion. Filed Aug. 4, 1958.

PAUL P. O'BRIEN,
Clerk.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 15821

JOHN R. HANSEN, ET AL., APPELLANT,

vs.

COMMISSIONER OF INTERNAL REVENUE, APPELLEE

Upon Petition to Review a Decision of The Tax Court of the United States.

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the decision of the said Tax Court of the United States in this Cause be, and hereby is affirmed as to the penalties assessed, but as to the imposition of tax on the dealer reserves the decision is reversed, and that this cause be, and hereby is remanded to the said Tax Court for recomputation and entry of judgment in accordance with the opinion of this Court.

APPENDIX B

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [as amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * * *

(26 U.S. C. 1952 ed., Sec. 42.)

Rev. Rul. 57-2, 1957-1 Int. Rev. Bull. 17:

> Amounts withheld by banks or finance companies to cover possible losses on notes purchased from dealers constitute income to dealers employing the accrual method of accounting, to the extent of their interest therein at the time the amounts are recorded on the books of the bank or finance company as a liability to the dealer, regardless of whether charges for worthless notes are also made to the account pursuant to an agreement between the parties. Losses sustained on worthless notes shall be separately established by the dealer as required by section 166 of the Internal Revenue Code of 1954.

The Internal Revenue Service has been requested to state its position with respect to the treatment, for Federal income tax purposes, of amounts withheld by banks and finance companies to cover possible losses on notes purchased from automobile or other dealers employing the accrual method of accounting, and which are recorded on the books of the bank or

finance company as a liability of the bank or finance company to the dealer.

The steps generally involved in transactions concerning automobile dealers are as follows: When a car is purchased on credit from a dealer, the purchaser makes a down-payment, either in the form of cash or by turning in another car at an agreed value, the balance being satisfied by the purchaser's promissory note and a supporting conditional sales contract. The face amount of the note reflects two elements—the balance of what would be the purchase price of the car, if bought for cash, and a finance charge. As between the purchaser and the dealer, the transaction is closed and completed at this point with the attendant tax consequences to the dealer.

It is then common practice for the dealer to sell or discount the purchaser's note and sales contract to some financial institution. The finance company or bank acquires the note at a value somewhat less than its face value, the difference representing a charge for its service. Simultaneously, either cash or unrestricted credit is given to the dealer to the extent of the amount reflected in the face value of the note that corresponds to the unpaid balance of the cash retail price of the car. The difference between the face value of the note and the sum of the finance company's charge and its credit or immediate payment to the dealer (representing part of the finance charge previously mentioned) is then credited on the books of the finance company as a liability of the finance company to the dealer. The accumulation of these credits is generally known as a "dealers reserve" and is the specific object of the present consideration.

Settlement of the liability represented by the reserve is subject to agreement between the particular

dealer and the financial institution involved. In some instances, the agreement does not contemplate the charging of any items against the reserve account, while in others the account reflects a running record of various transactions between the parties, that is, both credits and charges are entered, depending upon the nature of the item. Thus, in certain instances, the dealer and the finance company may agree that notes purchased or discounted are to be charged to the reserve account in the event they become worthless.

With regard to those instances where losses incurred by a finance company on notes purchased from automobile dealers may not be charged against the reserve, the credits to the reserve, by the finance company in favor of a dealer who employs the accrual method of accounting constitute income to the dealer at the time such credit is made, even though the dealer is not immediately or even currently able to draw on the entire reserve. See G. C. M. 9571, C. B. X.-2, 153 (1931), and *Shoemaker-Nash, Inc.* v. *Commissioner,* 41 B.T.A. 417. The principles involved in the purchase of notes from automobile dealers by banks or finance companies as described above are equally applicable where notes are purchased, under similar conditions, from dealers in items other than automobiles.

Where a dealer's reserve is in the nature of a running account, the charging thereto of worthless notes pursuant to agreement between the parties has no bearing upon the fact that taxable income has been received by the dealer, or upon the time of its realization as otherwise evidenced by the credits to such reserve.

Accordingly, it is held that credits to such reserve, in the case of a dealer employing the accrual method

of accounting, constitute income to the dealer at the time such credits are made regardless of whether charges to the account for worthless notes are also made pursuant to an agreement between the parties. Losses sustained on worthless notes are to be separately established by the dealer as required by the provisions of section 166 of the Internal Revenue Code of 1954 relating to bad debts.

In arriving at these conclusions, consideration has been given the case of *Blaine Johnson et al.* v. *United States*, 233 Fed. (2d) 952. See also, *Albert M. Brodsky et ux.* v. *Commissioner*, 27 T.C. No. 23.

APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

No. 13,421

J. H. SCHAEFFER, JR., AND OPAL R. SCHAEFFER, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

On Petition for Review of the Decision of the Tax Court of the United States.

Decided August 20, 1958.

Before: SIMONS, Chief Judge, MILLER, Circuit Judge, and CECIL, District Judge.

MILLER, Circuit Judge. The petitioners filed this action in the United States Tax Court seeking a redetermination of deficiency income tax assessments for the years 1952 and 1953, resulting from the failure on the part of the petitioners to include in gross income certain credits in their favor on the books of a finance company, which the Commissioner ruled constituted accrued taxable income. The Tax Court upheld the assessments, which ruling is now before us on petition for review.

The facts, which were for the most part stipulated, were found by the Tax Court as follows. Petitioners, who are husband and wife, are residents of Germantown, Tennessee. They filed joint Federal income tax returns for the years 1952 and 1953. J. H. Schaeffer, Jr., the husband, hereinafter referred to as "petitioner" operated a retail used automobile business as an individual proprietor during 1952 and 1953 under

the trade name of J & S Motors. The books and accounts of the business were kept on an accrual basis. In the normal course of the operation of the business petitioner sold notes executed by purchasers of automobiles under conditional sale contracts to banks and finance companies. Certain notes executed by such purchasers were sold in 1952 and 1953 by petitioner without recourse on petitioner to Memphis Bank & Trust Company and Guardian Discount Company, both of Memphis, Tennessee. These were closely related corporations in organization, operation and business practices, having the same principal place of business, and for the purposes of this opinion will be referred to collectively as the "Finance Company."

During 1952 and 1953 whenever notes, executed by purchasers of automobiles from J & S Motors and secured by conditional sales contracts on such automobiles, were purchased from J & S Motors by the Finance Company certain payments were made to J & S Motors and certain reserves were withheld and credited to two separate and distinct reserve accounts on the books of the Finance Company. These reserves were identified on such books as "Loss Reserve" accounts and "Special Reserve" or "Rebate" accounts. Whether the amounts credited by the Finance Company to the Loss Reserve accounts constituted taxable income for the years 1952 and 1953 is the question presented. Contrary to their original contention, petitioners now concede that the amounts credited to the Special Reserve or Rebate accounts constituted taxable income, and no issue is presented on the present review with respect thereto.

Under the agreement between petitioner and the Finance Company, the amounts withheld and credited to the Loss Reserve accounts were usually 2 per cent of the notes. However, the percentage withheld varied

in amount with the model of the car, and a larger percentage was withheld on older models. The creation and operation of the Loss Reserve accounts is shown by the following typical transaction. J & S Motors, in selling an automobile to a customer, would first obtain from the customer a credit statement which it submitted to the Finance Company. If the purchaser's credit was satisfactory J & S Motors made out a bill of sale indicating who held the lien on the automobile and informing the purchaser where payments were to be made. The purchaser would sign a conditional sale contract and make a down payment, consisting of a trade-in or cash or both. The following is an example of such a sale made July 26, 1952.

Cash Price	$833.00
Net trade-in allowance	228.00
Cash on delivery	60.00
Total down payment	288.00
To finance	545.00
Sales tax	6.90*
Insurance costs	100.07
Finance charges	195.53
Total time balance	840.60

Upon completion of a sale J & S Motors would take the conditional sale contract to the Finance Company and receive from it a check for the balance of the purchase price. In the sale of July 26, 1952, referred to above, the Finance Company reflected the purchase of the conditional sale contract as follows.

Notes Receivable	$840.60
Cash, payment to J & S Motors	545.00
Cash, payment of insurance premium	100.07
Loss reserve, J & S Motors	24.23

* This item was apparently not included in computing the total.

Special rebate, J & S Motors	113.33
Income	57.97
Total	$840.60

The books of J & S Motors did not reflect the reserves as income. The only amount recorded as income from the sale of an automobile was the price of the car, as if cash had been paid. By agreement between petitioner and the Finance Company, the Loss Reserve accounts of petitioner were chargeable with any and all losses and costs incurred by the Finance Company in connection with or related to notes purchased from the petitioner. In addition, there was a verbal agreement between petitioner and the Finance Company that J & S Motors would further guarantee the company against loss by repurchasing repossessed cars from it at a fair retail price.

No amounts were payable to petitioner out of such Loss Reserve accounts until the balance of such accounts exceeded 4 per cent of the total value of outstanding and unpaid balances on all notes purchased from petitioner. No payment was to be made out of such accounts as long as any debt owed by petitioner to the Finance Company was due and unpaid. During all of 1952 and 1953 amounts credited to the Loss Reserve accounts on the books of the Finance Company were held as security against losses on notes purchased from J & S Motors. The balances on Loss Reserve accounts did not at any time during 1952 or 1953 exceed 4 per cent of the outstanding value of or amount payable on notes purchased from J & S Motors by the Finance Company. During 1952 and 1953 the petitioner did not receive any of the Loss Reserves credited on the books of the Finance Company. However, if all of the purchasers of automobiles whose notes were held by the Finance Company had met their payments on

time, J & S Motors was entitled to receive the entire balances in the accumulated Loss Reserve accounts.

None of the amounts added to the Loss Reserve accounts were treated or reported as income by the petitioners. The deficiency assessments herein involved resulted from the Commissioner's ruling that petitioner's net income for the years in question should be increased by the amount of the net increases during 1952 and 1953 in the Loss Reserve accounts. Such net increases were $4,064.29 and $8,481.95, respectively, with the net balance increasing from $2,268.74 on December 31, 1951, to $14,814.98 on December 31, 1953. The Commissioner did not include in taxable income all of the amounts added to the Loss Reserve accounts in a particular year, but included only the net increases in such accounts, after allowing for actual losses arising out of defaults occurring in each of the taxable years.

Since petitioner was on an accural basis for income tax purposes, the amounts in question constituted taxable income if they accrued to the petitioner during the taxable year, even though he did not actually receive them during the year. "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues." *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182, 184-185; *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 423. The application of this well settled rule to cases involving factual situations similar to the present one has been the subject of considerable litigation. The petitioners' contention that the credits did not accrue as income in 1952 and 1953 finds support in *Johnson* v. *Commissioner*, 233 F. (2)

952, C.A. 4th; *Texas Trailercoach, Inc.*, v. *Commissioner*, 251 F. (2) 395, C.A. 5th; and *Glover* v. *Commissioner*, . . . F. (2) . . . , C.A. 8th, decided April 23, 1958. See also: *Commissioner* v. *Cleveland Trinidad Paving Co*, 62 F. (2) 85, C.A. 6th; *Keasbey & Mattison Co.* v. *United States*, 141 F. (2) 163, C.A. 3rd. The Commissioner's contention is supported by numerous tax court decisions, including *Shoemaker-Nash, Inc.*, v. *Commissioner*, 41 B.T.A. 417; *Brodsky* v. *Commissioner*, 27 T. C. 216; and *Kilborn* v. *Commissioner*, 29 T.C. No. 14, decided October 24, 1957, and by *Baird* v. *Commissioner*, . . . F. (2) . . . , C.A. 7th, decided June 20, 1958. Three of the cases relied upon by petitioners, *Johnson* v. *Commissioner*, supra, *Texas Trailercoach, Inc.*, v. *Commissioner*, supra, and *Glover* v. *Commissioner*, supra, are reversals of Tax Court decisions which also upheld the Commissioner's contention. The opinions in the cases above referred to contain a review of the authorities and a thorough discussion of the question, which it is unnecessary to repeat in this opinion. Basically, the cases sustaining the petitioners take the position that the amounts credited to the Reserve Loss accounts were payable to the petitioner only upon various conditions precedent, which were contingencies which might bar indefinitely the dealer's receipt of the payments or the right to receive any payments at all from the account, thus constituting them contingent credits, rather than accrued income. The cases supporting the Commissioner's contention express the view that the amounts credited by the Finance Company to the Reserve Loss accounts were carried by the Finance Company and recognized by it as a liability in favor of the petitioner, that petitioner's legal right to them was undisputed, and that only the time of payment was deferred. *Franklin County Distilling Co., Inc.*, v. *Commissioner*, 125 F. (2) 800, C.A.

6th. The fact that the exact amount to be paid is not determined until a later year is not material. *Continental Tie & Lumber Co.* v. *United States,* 286 U.S. 290, 295.

We agree with the Commissioner that there was nothing contingent about petitioner's legal right to the amounts so credited. The only contingency which existed was how much of these amounts would not be paid to the petitioner but would be applied by the Finance Company to the payment of petitioner's legal obligations. The contingency was in the amount of the offset, not in the amount of the accrued income. *Brown* v. *Helvering,* 291 U.S. 193, 200-201. For income tax purposes, the amount of accrued income was fixed and did not vary. Although the amount of the credit on the books of the Finance Company might be later reduced, such reduction would be the result of the Finance Company using a portion of the credit to discharge petitioner's legal obligations, which automatically offset any reduction in the credit. The payment of a legal obligation of a taxpayer is income to the taxpayer even though such income is not actually received by him. *Old Colony Trust Co.* v. *Commissioner,* 279 U.S. 716, 729; *Tressler* v. *Commissioner,* 228 F. (2) 356, 359, Note 6, C.A. 9th; *Northern Trust Co. of Chicago* v. *United States,* 193 F. (2) 127, C.A. 7th. The immediate payment of the amounts so credited was prevented only because petitioner pledged these amounts to secure other possible obligations of his own that might later arise.

The liabilities, the payment of which was secured by the Loss Reserve accounts, were contingent liabilities of the petitioner, such as *might* result from probable default on the part of the obligors in making the required payments. *Bernstein* v. *United States,* 234 F. (2) 475, 481, C.A. 5th. The tax on income received in

one year can not be withheld because losses may thereafter occur in a later year or because the ultimate result of a particular transaction may be a loss instead of a profit. *Heiner* v. *Mellon*, 304 U.S. 271, 276; *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 364. Such obligations can be taken as income tax deductions only in the year in which they become actual liabilities. *Brown* v. *Helvering*, supra, 291 U.S. 193, 200-201; *E. H. Sheldon & Co.* v. *Commissioner*, 214 F. (2) 655, 656, C.A. 6th; *Franklin County Distilling Co., Inc.*, v. *Commissioner*, supra, 125 F. (2) 800, 804, C.A. 6th. When a taxpayer is on the accrual basis losses are handled separately from income even though they relate to an item of gross income which has accrued in the same year. *Spring City Foundry Co.* v. *Commissioner*, supra, 292 U.S. 182, 185. Under the ruling in *Brown* v. *Helvering*, supra, 291 U.S. 193, and *Heiner* v. *Mellon*, supra, 304 U.S. 271, 276, the Commissioner's position must be sustained.

The foregoing analysis of the question considers the transaction only as one between the petitioner and the Finance Company. Before that transaction was entered into, the petitioner concluded a prior transaction with the purchaser of the automobile which, we believe, is the controlling factor in the case. Petitioner in selling a car to a purchaser and in taking the purchaser's note and conditional sale contract acquired an asset in the nature of an account receivable, with respect to which there was no contingency whatsoever. As between petitioner and the purchaser of the automobile, the entire amount of the contract obligation accrued to the petitioner. If such account receivable became uncollectible in whole or in part, the question was one of taking a deduction under the applicable statute. *Spring City Foundry Co.* v. *Commissioner*, supra, 292 U.S. 182, 185. There was no obligation on the part of the peti-

tioner to sell this account receivable to the Finance Company. Actually, in a number of instances the petitioner did not sell such an account receivable and the amount called for by his contract was treated by him as taxable income. We see no reason why the completed transaction with the purchaser should not be treated in the same way in other instances where the petitioner without any legal obligation on his part to do so sells the account receivable to a finance company. The income has accrued to the petitioner before the transfer is made to the Finance Company, and such subsequent transfer does not change the legal effect of the prior completed transaction. *Baird* v. *Commissioner*, supra, . . . F. (2) . . . , C.A. 7th. See: *Chamberlin* v. *Commissioner*, 207 F. (2) 462, 469, C.A. 6th, cert. denied, 347 U.S. 918.

The decision of the Tax Court is affirmed.

IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

No. 12230

SEPTEMBER TERM, 1957 APRIL SESSION, 1958.

CLIFTON E. BAIRD and VIOLET L. BAIRD, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Petition for Review of Decisions of the Tax Court of the United States.

June 20, 1958

Before SCHNACKENBERG and PARKINSON, *Circuit* Judges, and PLATT, *District Judge*.

SCHNACKENBERG, *Circuit Judge*. Clifton E. Baird and Violet L. Baird, husband and wife, filed a petition for review of decisions of the Tax Court of the United States in a proceeding initiated by petitions filed by them in that court. Evidence consisting of exhibits and testimony was received by the Tax Court, which entered findings of fact and filed an opinion.[1] The decisions now under attack determined income tax deficiencies for the years 1952, 1953 and 1954, in the amounts of $16,499.72, $23,086.16, and $7,434.72, respectively.

The facts are stipulated by the parties[2] and as found by the Tax Court may be summarized as follows:

Taxpayers are husband and wife residing in Salem, Indiana. They filed joint returns on a cash basis for the calendar years involved with the district director of In-

[1] Tax Court Memo. No. 192 (1957).

[2] The stipulation included, *inter alia*, certain testimony in a prior case of *Blaine and Evelyn K. Johnson*, No. 52306, in the Tax Court.

ernal Revenue for the District of Indiana. They are equal partners, doing business under the name Baird Trailer Sales. The partnership has engaged since its organization in January, 1947, in the sale of new and used mobile homes, or house trailers, and to a lesser extent in new and used cars, parts and accessories, furniture, and real estate, in Salem, Indiana.

Partnership returns were filed for the fiscal years ended February 28, 1952, 1953, and 1954,[3] and an amended return for the fiscal year ended February 28, 1952. The partnership kept its books and filed its income tax returns on an *accrual method* of accounting. The partnership books reflect the following gross sales and costs of sales for the relevant years:

	1952	1953	1954
Gross sales	$1,025,943.89	$1,337,385.64	$1,067,144.18
Cost of sales	859,746.75	1,141,308.59	908,027.87

During that period, the partnership sold to either of two finance companies or a bank[4] unpaid notes, chattel mortgages and conditional sales contracts.[5] The proceeds of such sales were paid by the finance companies to the partnership, with this exception: a part was withheld by each finance company and credited to the dealer's reserve account of the partnership on the finance company's books.[6] The partnership either endorsed with recourse retail paper sold to the finance companies or guaranteed its payment. It was agreed between the partnership and the finance companies:

> (a) In the event the retail paper became due and unpaid, the finance company could charge the dealer's reserve with the unpaid balance;

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[3] Herein sometimes referred to as the "relevant years".

[4] All sometimes referred to herein as "finance companies".

[5] Herein sometimes referred to as "retail paper".

[6] The part withheld by the bank was deposited in an account designated "dealer eserow account" in the name of the partnership.

(b) In the event the partnership had a matured financial obligation of any nature to the finance companies,[6a] the amount of such obligation could be charged to the dealer's reserve account;

(c) Repossession losses of the finance companies[6a] could be charged to the dealer's reserve account;

(d) The ultimate balance in the dealer's reserve account after payment of all notes by the partnership to the finance companies[6a] was to be paid to the partnership; and

(e) Each finance company could look to the balance in the dealer's reserve account to satisfy any default by the partnership on its guaranties and obligations to the finance company, as well as any default by the makers of the notes.

The partnership was not required by any finance company to do business with it to the exclusion of any other company.

The partnership was not financially able to carry the contracts of sale or the floor plan and carry the inventory of trailers held for sale, but relied upon the finance companies. For its own convenience, it procured and used in its sales legal forms furnished by the finance companies.

The account on each finance company's books designated "dealer's reserve" for the partnership was reflected as a liability of the finance company and the annual balances in such account were not reflected in its income.

During the relevant years, the partnership (by way of illustration) recorded the sale of a trailer and the sale of the retail paper on its books and records as follows:

[6a] The word "companies" appears in the stipulation from which the quoted paragraphs are taken.

Sales Receipt Journal Entry		
Cash and/or Trade-in Allowance	$1,745.00	
Contracts Receivable-Finance Company	3,800.00	
Trailer Sales		$5,545.00

When the finance company remitted to the partnership, the following entry was made:

Reserve-Finance Company	$ 190.00	
Cash	3,632.67	
Expense for Intangible Stamps	1.38	
Contracts Receivable		$3,800.00
Expenses (Credit Check)		24.05
Cost of Sales		$3,824.05
Cost of Sales	$3,824.05	
Credit Inventory		$3,824.05

When a purchaser defaulted on his contract and note, the trailer was repossessed upon receipt of notice of default. The partnership always paid the finance company the unpaid balance due on such note and recorded such payment on its books and tax returns as a purchase. Where defaults occurred on the notes payable to the partnership, the payments made to the finance companies as a result of the defaults were included on the partnership's returns for the relevant years as a part of cost of goods sold. On resale of the repossessed trailer, the receipts therefrom were reported as gross receipts.[7]

[7] For example, if a trailer costing $5,545 with notes payable outstanding of $3,500 was repossessed and the trailer's fair market value was only $3,000, the loss, if any, was reflected on the partnership's books and records as part of cost of goods as follows: The bookkeeper of the partnership either on the date of repossession or at the close of the fiscal year charged $500 to overallowance on trailers and recorded the purchase price of the trailer in cost of used trailers at $3,000 (its fair market value). However, if the trailer was sold during the fiscal year in which it was repossessed, and the bookkeeper had not charged $500 to overallowance on trailers, the purchase price of the trailer was reflected in cost of used trailers at $3,500, and the sales price of $3,000 reported in gross receipts. In the event the notes payable outstanding were $3,000 or less in the above example, the purchase price of the trailer was reflected in cost of used trailers at the amount paid by

The following table shows the amounts credited on the books of said finance companies in the dealer reserve accounts of the partnership and the amounts it received from those and other finance companies in the years indicated:

Fiscal year ended February 28	Credited by said finance companies in dealer reserve accounts of partnership	Received by partnership from all finance companies
1952	$25,816.58	$1,217.94
1953	29,560.54	1,778.94
1954	29,660.49	9,141.39

On its returns for the relevant years, the partnership deducted specific bad debts in the respective amounts of $1,203.75, $2,239.12, and $1,203.69. Such deductions included unpaid amounts due the partnership for accessories, supplies and repairs. But what is significant here is that such deductions also included advances by the partnership to meet trailer purchaser's payments which the purchaser was unable to make and after advancement a default by the purchaser occurred.

In computing the gross receipts reported in its returns for the relevant years, the partnership deducted from gross sales the total amount credited by the finance companies in each year to the partnership's account designated "dealer's reserve". However, the Commissioner included such amounts in the partnership's income. In determining the contested deficiencies, the Commissioner reduced the total amounts credited by the finance companies to the partnership dealer's reserve accounts by the amounts received by the partnership from the finance companies in the relevant years,

---

the partnership on the unpaid balance of the note payable. The finance company remitted to the partnership the amount which had been credited to the account designated "dealer's reserve" with respect to such defaulted contract and note and the partnership reported such amount in taxable income for the year of receipt, except for the years 1948 and 1949, when the credit to the amounts designated "dealer's reserve" were included in taxable income.

and added the net amounts to the partnership income.

No delinquent notes were charged to the partnership's dealer's reserve accounts by any finance company during the relevant years. During these years the finance companies were in such good financial condition that they were able to pay any accounts which might have been due and payable to the partnership out of the dealer's reserves.

The Tax Court held that the amounts of the dealer's reserves withheld by the finance companies during the relevant years and credited to the partnership's account on the finance companies' books were includible in taxpayers' taxable income in the years withheld and credited.

Taxpayers argue that the amounts withheld by finance companies and credited to dealer's reserve accounts on their books are not accruable in the year of withholding because extreme contingencies rendered most uncertain the right of taxpayers to such amounts; that the agreements between the partnership and each of the finance companies severely restricted the right of the petitioners to the amounts withheld; that the hold-back and other restrictive provisions of these agreements were dictated by the finance companies to protect themselves against losses; that the partnership was forced to acquiesce in these unfavorable terms in order to do business with the finance companies; and that the credits in the dealer's reserve accounts were not partnership assets. Finally they argue that the trailer contracts and notes were sold by the partnership solely because of its immediate needs for cash funds, since the business would have been much more profitable if the partnership had been financially able to retain such paper.

The Commissioner argues, in part, that the Tax Court correctly held that amounts withheld by finance companies, in purchasing trailer and automobile notes and

contracts from the partnership, and credited to reserve accounts in its name on the finance companies' books were includible in the taxpayers' gross income for income tax purposes in the years withheld and credited. Since the partnership was on the accrual basis, the entire profit to it from the sale of trailers and automobiles was properly includible in taxpayers' gross income at the time of sale, even though some deferred payments would not be received until a subsequent period and even though there was a possibility that the purchasers would default. He concluded that the partnership's practice of accruing less than the entire sales price is inconsistent with the accrual method of accounting.

At the outset we consider what amounts to a plea for sympathy and equitable relief made by taxpayers:

> "It is obvious that the high risk element in the sale of house trailers severely limited the market for trailer coach paper and gave heavy bargaining leverage to financing institutions. As a result, the finance companies have come to exercise considerable control over a dealer's business practices and frequently participate in and police a dealer's sales.
>
> * * * * *
>
> "The general uncertainty of the partnership in its relationship with the finance companies is also illustrated by the fact that the sale of contracts and notes took place only because the partnership was in pressing need of funds. * * *
>
> "It is obvious that the partnership would have been much more profitable if it had been able to retain the notes and contracts received from the purchasers of its trailers. If it had been able to go forward in this fashion, it could have then realized not only the profit on the sale of the trailer, but the

not inconsiderable amounts which flowed from the finance charges and other 'extras.' If the partnership had been able to hold its own paper and had not been required to discount it with the finance companies, it could have reaped the financial harvest which the finance companies were able to obtain.

* * * * *

"The basic agreements disclose that the partnership was at the mercy of the finance companies in the arrangements which are involved in the instant cases. The contingencies on payments to the partnership were created by the finance companies for their protection, not by the partnership."

While we admire the courage of those who, without sufficient capital, enter into a competitive business field, where (it is asserted) risks are high and many,[8] we are aware that such an entry is voluntary and we know of no power which courts have to grant relief from the burden of income tax laws to persons who thus find themselves "at the mercy of the finance companies." Congress has power to lay and collect income taxes.[9] If the application of the income tax law to persons situated as taxpayers say they were, requires special consideration, it is for Congress to say so, not us. Our duty is to ascertain what the law is and apply it to this case.

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[8] This assertion by taxpayers is refuted by the record, which shows that for the relevant years no delinquencies were charged to the dealer's reserve accounts by any finance company, and further that during said years the total deductions by the partnership for bad debts, *only a part of which were advances by the partnership to meet defaults in payment by purchasers*, amounted to only $1,203.75, $2,239.12 and $1,203.69. As hereinbefore shown, the gross sales for the same years were each well over one million dollars.

[9] Amendment XVI of the Constitution of the United States.

We may well start with *Spring City Co.* v. *Commissioner*, 292 U.S. 182, which affirmed this court, 67 F.2d 385. At 184, the Chief Justice said:

> "* * * Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. When a merchandising concern makes sales, its inventory is reduced and a claim for the purchase price arises. * * *"

In a layman's language, an accrual method means that you report income when earned, even if not received, and deduct expenses when incurred, even if not paid, within the taxable period.

In the case at bar, the partnership, in a typical case, completed the transaction of the sale of a trailer at the time the down payment was made, either in cash or trade-in allowance, or both, and the purchaser executed and delivered to it notes and a chattel mortgage or conditional sales contract. The partnership thus acquired a complete enforcible right to receive the remainder of the purchase price at the times specified in the retail paper. The circumstance that the partnership was or was not financially able to retain the paper and collect it as it became due does not preclude the fact that its entire profit on the transaction *accrued* at that time regardless of when received. Therefore, no portion of the profit is rendered nontaxable at that time by the subsequent act of the partnership in selling the retail paper to a finance company in a transaction which left a part of the sales price of the paper temporarily retained as security by the finance company. It is significant and consistent with the law that the finance companies did not take into income the amounts cred-

ited on their books to the partnership in the dealer's reserve accounts.

Ultimately only two things could happen to the funds in the dealer's reserve accounts: either the amounts would be paid to the partnership in cash or they would be used to satisfy the partnership's other obligagations to the finance companies. There is no showing that the amounts in the reserve would not be collectible from the finance companies at the appropriate time or that their collection would be improbable, for the companies were in sound financial condition and at all times able to pay out the amounts withheld in the reserves. The only thing which would prevent the partnership from receiving the full sales price would be a purchaser's default, which is not a contingency sufficient to defer the accruing of income that has already been earned. If the partnership eventually sustains such a loss, it is recognized that it would be entitled to a business deduction therefor, because it would be a debt, or portion thereof, arising from sales that had been included in income, and which was thereafter ascertained to be worthless. Actually the partnership elected, on its returns for the relevant years, to use the bad debt deduction method, when it deducted for those years the amounts hereinbefore referred to. Significantly these amounts consisted, in part, of advances made by the partnership to the finance companies to meet trailer purchaser's payments which the purchaser was unable to make and, after advancement, the purchaser defaulted.

Taxpayers do not seek to take advantage of 26 U.S.C.A. 23 (k) (1) of the 1939 Internal Revenue Code, insofar as a deduction, in the computation of net income, is allowed ("in the discretion of the Commissioner") for a reasonable addition to a reserve for bad debts. This position taxpayers are forced to take because of their contention that the withheld part of the

sale price did not accrue to them during the relevant years. However, quite inconsistently with their argument that the withheld amounts were not accrued income to the partnership, the latter did claim, as deductions, debts included in said accounts which defaulted within the relevant years. As the court said in *Rogan v. Commercial Discount Co.*, 149 F.2d 585,[10] at 586:

> "At all times pertinent to this inquiry, the taxpayer was operating under the reserve method for handling bad debts and did not employ the charge-off method. The statute allows these alternative methods, but having made an election as to which method it would adopt, it could not change to the other method in the absence of the Commissioner's express permission. * * *"

It is, therefore, apparent that, although § 23(k)(1) permits the deduction of *either*, first, specific debts which become worthless within the taxable year or, secondly, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts, the partnership chose to use the specific debt charge-off method for bad debts, and should not be allowed any deductions as a reserve for bad debts.

In *Universal Oil Products Co.* v. *Campbell*, 181 F.2d 451, (cert. denied, 340 U.S. 850, rehearing denied, 340 U.S. 894) at 470, we said:

> "Vague possibilities that income may have to be returned, or that it may possibly be subject to diminution or off-set will not alone suffice to postpone the accrual and reporting of taxable income. * * *"

We then referred to *Helvering* v. *Nibley-Mimnaugh Lumber Company*, 63 App. D.C. 181, 70 F.2d 843, where

[10] Cert. denied, 326 U.S. 764.

a contract for sale of timberland was executed in 1923 and it was provided that part of the purchase price was paid in cash and the balance thereof by promissory notes secured by a mortgage. The contract further provided that taxpayer should furnish abstracts and that, for certain contingencies as to failures of title and as to there being a smaller amount of timberland than specified in the contract, there should be a reduction in the purchase price. Such reductions, if any, were to be applied against the principal of the notes. We said, at 471 of the *Universal Oil* case:

> "* * * By reason of a shortage in the timberland, determined in 1924, it was agreed between the parties that more than $66,000 of the stated sale price should be deducted from the notes representing the balance of the purchase price. The Court held that if the taxpayer was reporting and paying taxes on an accrual basis, the facts shown were sufficient to accrue the entire purchase price in 1923, even though the agreed price was conditionally subject to abatement. The Court said that the right of the seller to have the notes paid, accrued in 1923, because it then became a fixed and unconditioned liability. It is significant that in that case there was, as here, a condition which provided for a proportionate reduction in the purchase price in the event of the happening of a certain contingency."

Our conclusions, therefore, were:

> "We see from these decisions that it is not every contingency that prevents the accrual of income. The contingency must be real and substantial. * * *
>
> * * * * *
>
> "* * * We must, therefore, hold that it was the duty of plaintiff to accrue and report as a part of its

1945 income the total amount of $1,035,205, which it was to receive as its share of the consideration for the license."

To the same effect are *Commissioner of Internal Revenue* v. *Union Pac. R. Co.*, 86 F.2d 637, 639; *Frost Lumber Industries* v. *Commissioner of Int. Rev.*, 128 F.2d 693, 696; and *Clark* v. *Woodward Construction Co.*, 179 F.2d 176, where the court, at 177, said: "The decisive factor is the creation of an enforceable liability."

In the case at bar, each sale was a transaction solely between the purchaser and the partnership. They agreed on the terms of sale, including the selling price, the down payment, the trade-in allowance, and the terms for deferred payments. The purchaser made his down payment to the partnership and delivered his traded-in vehicle to it, together with the executed retail papers. The purchaser went his way and the partnership kept the down payment and the traded-in vehicle. It was the decision of the partnership as to which finance company it would offer the retail paper. It had complete freedom of choice in this regard and conversely each finance company was free to take or refuse the offered paper. Transfer of the paper to a finance company resulted in the partnership receiving the balance of the purchase price, minus the withheld portion, the year of taxability of which is now the subject of this litigation. When this reserve had served its purpose, the partnership would also receive what remained in that fund.

Since the partnership used the accrual method of accounting, its entire profit from the sale should be reported when it accrued, regardless of when received.

Taxpayers contend that the partnership's "right to the amounts withheld from the purchase price of notes was so contingent during the taxable period that such amounts should not be accrued as taxable income in

the years withheld by the finance companies." While it is possible that the partnership would not receive all of the amounts in cash, the parts withheld would in all events be used for the benefit of the partnership to satisfy its future obligations, if any, to the finance companies. Taxpayers confuse the arrangement with respect to *payment* of the sums in the reserve accounts with the vesting in the partnership in the relevant years of a fixed right to receive in due course definite sums which had become accruable to it at the times of sale in the relevant years. There is no uncertainty with respect to the amounts accrued during the relevant years. These amounts were definitely fixed at the time the funds were placed to the partnership's credit in the dealer's reserve accounts. Moreover, there is no showing that the amounts in the reserve accounts would not be collectible at the appropriate time or that collection would be improbable, as we have pointed out, *ante* 5. In the light of the record, it cannot logically be argued that the reserve would never be realized by the partnership.

In its reply brief, the partnership, for the first time, argues that it could have obtained the benefits of reporting its income under the installment method, if it had been financially able to hold the retail paper instead of selling it to finance companies. Evidently referring to 26 U.S.C.A. § 44(a), it argues that an accrual basis taxpayer is entitled to report his installment sale profit in the taxable years that payments are actually recived. However, there is no showing by taxpayers that the partnership purported, in making its returns of income, to rely on § 44(a). Apparently the argument comes as an afterthought. It is not convincing.

Taxpayers have also called our attention to *Johnson* v. *Commissioner*, 233 F.2d 952, *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F.2d 395, and *Glover* v. *Commissioner*, 253 F.2d 735. Even if we ignore some of the

facts involved in these cases which are different from those involved in the case at bar, we adhere to the views herein expressed.

We affirm the decisions of the Tax Court.

AFFIRMED.

A true Copy:

Teste:

____, ____.

Clerk of the United States Court of Appeals for the Seventh Circuit.

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IN THE

Supreme Court of the United States

October Term, 1958

CLIFTON E. BAIRD AND VIOLET L. BAIRD,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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No. ———

CLIFTON E. BAIRD AND VIOLET L. BAIRD,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in the above-entitled case on June 20, 1958.

OPINIONS BELOW

The findings of fact and memorandum opinion of the Tax Court of the United States (R. 49-61) are not officially reported. The opinion of the Court of Appeals is reported at 256 F. 2d 918. (Appendix A, infra, p. 9).

JURISDICTION

The judgment of the Court of Appeals was entered on June 20, 1958. (Appendix B, infra p. 22). On September

17, 1958, the time for filing a petition for a writ of certiorari was extended by order of Mr. Justice Clark to and including November 17, 1958. (Appendix C, infra p. 23) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether amounts withheld upon assignment of installment contracts and credited by finance companies to an account designated "Dealer Reserve" in the name of petitioners, accrual basis taxpayers, are taxable as income in the tax year when credited or in the tax year when the petitioners have the right to receive payment.

STATUTE INVOLVED

The statutory provisions involved are Sections 22(a), 41 and 42 of the Internal Revenue Code of 1939, which are set forth in Appendix D, infra, p. 23.

STATEMENT

During the years 1952, 1953 and 1954 petitioners, copartners, were engaged in the retail business of selling mobilehomes, sometimes referred to as house-trailers. When the sales were made on credit the purchasers executed conditional sales contracts providing for payment of the purchase price in installments. Petitioners were required to use contract forms provided by the finance companies and under the requirements of the contracts they assigned such contracts after execution by trailer purchasers to the finance companies.

The contractual agreements with each finance company had minor differences, but in all material respects were the same. As each contract was assigned to a finance company, it would remit to the petitioners the balance due on the selling price of the trailer, less an

amount which was credited on the books of the finance company to an account designated "Dealer Reserve Account". Two of the finance companies with which petitioners did business also agreed to credit a portion of the future finance charge to petitioners under prescribed conditions. The amounts thus withheld by the finance companies were contingently payable to petitioners upon the subsequent fulfillment of certain conditions in the respective contracts.

During the taxable years 1952, 1953 and 1954, the partnership received and reported as taxable income the respective total amounts of $1,217.94, $1,778.94 and $9,141.39 from the Dealer Reserve accounts. The total amounts withheld by the finance companies and credited to the Dealer Reserve accounts during 1952, 1953, and 1954 were $25,816.58, $29,560.54 and $29,660.49 respectively. In determining the tax deficiencies, the Commissioner reduced such total credits by the foregoing reported amounts and thereby added the respective net amounts of $24,598.64, $27,781.61 and $20,519.18 to the taxable income of the partnership for 1952, 1953 and 1954. (R. 24, 25.)

The Tax Court sustained the Commissioner's determination, holding that the amounts thus withheld by the finance companies and credited to the Dealer Reserve Accounts on their books were taxable as income in the years withheld and credited. (R. 49-61.) The Court of Appeals affirmed the decision of the Tax Court. (Appendix B, infra p. 22).

REASONS FOR GRANTING THE WRIT

1. The decision is directly in conflict with the decision of the Court of Appeals for the Fourth Circuit in *Johnson* v. *Commissioner*, 233 F. 2d 952 and the decision of the Court of Appeals for the Fifth Circuit in *Texas*

Trailercoach, Inc. v. *Commissioner*, 251 F. 2d 395.[1] The decision below conflicts in principle with the decision of the Court of Appeals for the Eighth Circuit in *Glover* v. *Commissioner*, 253 F. 2d 735, the decision of the Court of Appeals for the Ninth Circuit in *Hansen* v. *Commissioner*, 258 F. 2d 585, and the decision of the Court of Appeals for the Third Circuit in *Keasbey & Mattison Company* v. *U. S.*, 141 F. 2d 163. The conflict is conceded by the respondent, both on brief (Respondent's brief p. 38) and in oral argument, except with respect to *Keasbey & Mattison Company* v. *U. S.*, *supra*. This conflict is also conceded by the Tax Court in its opinion. (R. 61.)

The Commissioner of Internal Revenue filed petitions for writ of certiorari in the *Glover* and *Hansen* cases on September 20, 1958. The Commissioner based his reasons for granting the writ on the conflict between the decisions in the Eighth and Ninth Circuits and the respective decisions of the Seventh and Sixth Circuits in the instant case and in the case of *Schaeffer* v. *Commissioner*, decided August 20, 1958.

In the petition in the *Hansen* case, the respondent stated (p. 4 and 5):

> "1. The decision below, which involves an important issue as to the accruability of income for tax purposes, is in direct conflict with the decision of the Sixth Circuit in *Schaeffer* v. *Commissioner*, decided August 20, 1958, (appendix C *infra*, pp. 26-34), and of the Seventh Circuit in *Baird* v. *Commissioner*, decided June 20, 1958, (1 A.F.T.R. 2d 58-2014) (Appendix C *infra*, pp. 35-49). There are no material factual differences in the cases, and the issue posed in all three is precisely the same."

---

[1] Since the Texas Trailercoach, Inc. decision the Fifth Circuit has reaffirmed in *West Pontiac, Inc.* v. *Commissioner*, decided February 6, 1958, *Modern Olds* v. *U. S.* decided September 15, 1958, *Kilborn* v. *Commissioner*, decided September 18, 1958, and *Hines Pontiac* v. *U. S.* decided September 18, 1958.

2. A determination of the question by this Court is clearly in the public interest. More and more the consumer economy of our country is based on the time-purchase system such as is involved in the instant case. Absent a decision by this Court, installment dealers in personal property throughout the country will continue to report their taxable income on different bases, according to the prevailing view of the judicial circuit in which they conduct their business. For both the administration of the tax laws and the establishment of equality among retail dealers in personal property throughout the land the issue should be resolved.

3. The decision below is believed to be erroneous and the conflicting decisions of the Third, Fourth, Fifth, Eighth and Ninth Circuits in the respective cases of *Keasbey & Mattison Company* v. *U. S.*, *Johnson* v. *Commissioner*, *Texas Trailercoach, Inc.* v. *Commissioner*, are believed to be correct. Moreover, it is urged that the decision below conflicts with applicable decisions of this Court in the cases of *Spring City Foundry Company* v. *Commissioner*, 292 U. S. 182 (1934), *Security Flour Mills Company* v. *Commissioner*, 321 U. S. 281 (1944), and *Dixie Pine Products Company* v. *Commissioner*, 320 U. S. 516 (1944).

In these three decisions, and in other decisions of this Court, the principle has been established that income accrues in the year when the right to receive becomes fixed. Further, these decisions hold that an accrual basis taxpayer is not required to include in taxable income amounts which he has not received, over which he has no control, and which he may never receive. It is urged that the decision below is contrary to these principles in taxing an installment sales dealer on the full amount of the purchase price in the year credits are made to an account of the finance company, rather than in the year the dealer's right to the credited amounts ripens into maturity.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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November 12, 1958

APPENDIX A

IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

No. 12230 SEPTEMBER TERM, 1957 APRIL SESSION, 1958.

Petition for Review of Decisions of the Tax Court of the United States

---

CLIFTON E. BAIRD AND VIOLET L. BAIRD,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

June 20, 1958

Before SCHNACKENBERG and PARKINSON, *Circuit Judges,* and PLATT, *District Judge.*

SCHNACKENBERG, *Circuit Judge.* Clifton E. Baird and Violet L. Baird, husband and wife, filed a petition for review of decisions of the Tax Court of the United States in a proceeding initiated by petitions filed by them in that court. Evidence consisting of exhibits and testimony was received by the Tax Court, which entered findings of fact and filed an opinion.[1] The decisions now under attack determined income tax deficiencies for the years 1952,

[1] Tax Court Memo. No. 192 (1957).

1953 and 1954, in the amounts of $16,499.72, $23,086.16, and $7,434.72, respectively.

The facts as stipulated by the parties[2] and as found by the Tax Court may be summarized as follows:

Taxpayers are husband and wife residing in Salem, Indiana. They filed joint returns on a *cash* basis for the calendar years involved with the district director of Internal Revenue for the District of Indiana. They are equal partners, doing business under the name Baird Trailer Sales. The partnership has engaged since its organization in January, 1947, in the sale of new and used mobile homes, or house trailers, and to a lesser extent in new and used cars, parts and accessories, furniture, and real estate, in Salem, Indiana.

Partnership returns were filed for the fiscal years ended February 28, 1952, 1953, and 1954,[3] and an amended return for the fiscal year ended February 28, 1952. The partnership kept its books and filed its income tax returns on an *accrual method* of accounting. The partnership books reflect the following gross sales and costs of sales for the relevant years:

	1952	1953	1954
Gross sales	$1,025,943.89	$1,337,385.64	$1,067,144.18
Cost of sales	859,746.75	1,141,308.59	908,027.87

During that period, the partnership sold to either of two finance companies or a bank[4] unpaid notes, chattel mortgages and conditional sales contracts.[5] The proceeds of

[2] The stipulation included, *inter alia*, certain testimony in a prior case of *Blaine and Evelyn K. Johnson*, No. 52306, in the Tax Court.

[3] Herein sometimes referred to as the "relevant years".

[4] All sometimes referred to herein as "finance companies".

[5] Herein sometimes referred to as "retail paper".

such sales were paid by the finance companies to the partnership, with this exception: a part was withheld by each finance company and credited to the dealer's reserve account of the partnership on the finance company's books.[6] The partnership either endorsed with recourse retail paper sold to the finance companies or guaranteed its payment. It was agreed between the partnership and the finance companies:

> (a) In the event the retail paper became due and unpaid, the finance company could charge the dealer's reserve with the unpaid balance;
>
> (b) In the event the partnership had a matured financial obligation of any nature to the finance companies,[6a] the amount of such obligation could be charged to the dealer's reserve account;
>
> (c) Repossession losses of the finance companies[6a] could be charged to the dealer's reserve account;
>
> (d) The ultimate balance in the dealer's reserve account after payment of all notes by the partnership to the finance companies[6a] was to be paid to the partnership; and
>
> (e) Each finance company could look to the balance in the dealer's reserve account to satisfy any default by the partnership on its guaranties and obligations to the finance company, as well as any default by the makers of the notes.

The partnership was not required by any finance company to do business with it to the exclusion of any other company.

The partnership was not financially able to carry the contracts of sale or the floor plan and carry the inventory

---

[6] The part withheld by the bank was deposited in an account designated "dealer escrow account" in the name of the partnership.

[6a] The word "companies" appears in the stipulation from which the quoted paragraphs are taken.

of trailers held for sale, but relied upon the finance companies. For its own convenience, it procured and used in its sales legal forms furnished by the finance companies.

The account on each finance company's books designated "dealer's reserve" for the partnership was reflected as a liability of the finance company and the annual balances in such account were not reflected in its income.

During the relevant years, the partnership (by way of illustration) recorded the sale of a trailer and the sale of the retail paper on its books and records as follows:

Sales Receipt Journal Entry		
Cash and or Trade-in Allowance	$1,745.00	
Contracts Receivable-Finance Company	3,800.00	
Trailer Sales		$5,545.00

When the finance company remitted to the partnership, the following entry was made:

Reserve-Finance Company	$ 190.00	
Cash	3,632.67	
Expense for Intangible Stamps	1.38	
Contracts Receivable		$3,800.00
Expenses (Credit Check)		24.05
Cost of Sales		$3,824.05
Cost of Sales	$3,824.05	
Credit Inventory		$3,824.05

When a purchaser defaulted on his contract and note, the trailer was repossessed upon receipt of notice of default. The partnership always paid the finance company the unpaid balance due on such note and recorded such payment on its books and tax returns as a purchase. Where defaults occurred on the notes payable to the partnership, the payments made to the finance companies as a result of the defaults were included on the partnership's

returns for the relevant years as a part of cost of goods sold. On resale of the repossessed trailer, the receipts therefrom were reported as gross receipts.[7]

The following table shows the amounts credited on the books of said finance companies in the dealer reserve accounts of the partnership and the amounts it received from those and other finance companies in the years indicated:

Fiscal year ended February 28	Credited by said finance companies in dealer reserve accounts of partnership	Received by partnership from all finance companies
1952	$ 25,816.58	$ 1,217.94
1953	29,560.54	1,778.94
1954	29,660.49	9,141.39

On its returns for the relevant years, the partnership deducted specific bad debts in the respective amounts of

[7] For example, if a trailer costing $5,545 with notes payable outstanding of $3,500 was repossessed and the trailer's fair market value was only $3,000, the loss, if any, was reflected on the partnership's books and records as part of cost of goods as follows: The bookkeeper of the partnership either on the date of repossession or at the close of the fiscal year charged $500 to overallowance on trailers and recorded the purchase price of the trailer in cost of used trailers at $3,000 (its fair market value). However, if the trailer was sold during the fiscal year in which it was repossessed, and the bookkeeper had not charged $500 to overallowance on trailers, the purchase price of the trailer was reflected in cost of used trailers at $3,500, and the sales price of $3,000 reported in gross receipts. In the event the notes payable outstanding were $3,000 or less in the above example, the purchase price of the trailer was reflected in cost of used trailers at the amount paid by the partnership on the unpaid balance of the note payable. The finance company remitted to the partnership the amount which had been credited to the account designated "dealer's reserve" with respect to such defaulted contract and note and the partnership reported such amount in taxable income for the year of receipt, except for the years 1948 and 1949, when the credit to the amounts designated "dealer's reserve" were included in taxable income.

$1,203.75, $2,239.12, and $1,203.69. Such deductions included unpaid amounts due the partnership for accessories, supplies and repairs. But what is significant here is that such deductions also included advances by the partnership to meet trailer purchaser's payments which the purchaser was unable to make and after advancement a default by the purchaser occurred.

In computing the gross receipts reported in its returns for the relevant years, the partnership deducted from gross sales the total amount credited by the finance companies in each year to the partnership's account designated "dealer's reserve". However, the Commissioner included such amounts in the partnership's income. In determining the contested deficiencies, the Commissioner reduced the total amounts credited by the finance companies to the partnership dealer's reserve accounts by the amounts received by the partnership from the finance companies in the relevant years, and added the net amounts to the partnership income.

No delinquent notes were charged to the partnership's dealer's reserve accounts by any finance company during the relevant years. During these years the finance companies were in such good financial condition that they were able to pay any accounts which might have been due and payable to the partnership out of the dealer's reserves.

The Tax Court held that the amounts of the dealer's reserves withheld by the finance companies during the relevant years and credited to the partnership's account on the finance companies' books were includible in taxpayers' taxable income in the years withheld and credited.

Taxpayers argue that the amounts withheld by finance companies and credited to dealer's reserve accounts on their books are not accruable in the year of withholding because extreme contingencies rendered most uncertain

the right of taxpayers to such amounts: that the agreements between the partnership and each of the finance companies severely restricted the right of the petitioners to the amounts withheld; that the holdback and other restrictive provisions of these agreements were dictated by the finance companies to protect themselves against losses; that the partnership was forced to acquiesce in these unfavorable terms in order to do business with the finance companies; and that the credits in the dealer's reserve accounts were not partnership assets. Finally they argue that the trailer contracts and notes were sold by the partnership solely because of its immediate needs for cash funds, since the business would have been much more profitable if the partnership had been financially able to retain such paper.

The Commissioner argues, in part, that the Tax Court correctly held that amounts withheld by finance companies, in purchasing trailer and automobile notes and contracts from the partnership, and credited to reserve accounts in its name on the finance companies' books were includible in the taxpayers' gross income for income tax purposes in the years withheld and credited. Since the partnership was on the accrual basis, the entire profit to it from the sale of trailers and automobiles was properly includible in taxpayers' gross income at the time of sale, even though some deferred payments would not be received until a subsequent period and even though there was a possibility that the purchasers would default. He concluded that the partnership's practice of accruing less than the entire sales price is inconsistent with the accrual method of accounting.

At the outset we consider what amounts to a plea for sympathy and equitable relief made by taxpayers:

> "It is obvious that the high risk element in the sale of house trailers severely limited the market for trailer coach paper and gave heavy bargaining leverage to financing institutions. As a result, the finance

companies have come to exercise considerable control over a dealer's business practices and frequently participate in and police a dealer's sales.

* * *

"The general uncertainty of the partnership in its relationship with the finance companies is also illustrated by the fact that the sale of contracts and notes took place only because the partnership was in pressing need of funds. * * *

"It is obvious that the partnership would have been much more profitable if it had been able to retain the notes and contracts received from the purchasers of its trailers. If it had been able to go forward in this fashion, it could have then realized not only the profit on the sale of the trailer, but the not inconsiderable amounts which flowed from the finance charges and other 'extras.' If the partnership had been able to hold its own paper and had not been required to discount it with the finance companies, it could have reaped the financial harvest which the finance companies were able to obtain.

* * *

"The basic agreements disclose that the partnership was at the mercy of the finance companies in the arrangements which are involved in the instant cases. The contingencies on payments to the partnership were created by the finance companies for their protection, not by the partnership."

While we admire the courage of those who, without sufficient capital, enter into a competitive business field, where (it is asserted) risks are high and many,* we are

* This assertion by taxpayers is refuted by the record, which shows that for the relevant years no delinquencies were charged to the dealer's reserve accounts by any finance company, and further that during said years the total deductions by the partnership for bad debts, *only a part of which were advances by the partnership to meet defaults in payment by purchasers*, amounted to only $1,203.75, $2,239.12 and $1,203.69. As hereinbefore shown, the gross sales for the same years were each well over one million dollars.

aware that such an entry is voluntary and we know of no power which courts have to grant relief from the burden of income tax laws to persons who thus find themselves "at the mercy of the finance companies". Congress has power to lay and collect income taxes.[9] If the application of the income tax law to persons situated as taxpayers say they were, requires special consideration, it is for Congress to say so, not us. Our duty is to ascertain what the law is and apply it to this case.

We may well start with *Spring City Co.* v. *Commissioner*, 292 U.S. 182, which affirmed this court, 67 F.2d 385. At 184, the Chief Justice said:

> "* * * Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. When a merchandising concern makes sales, its inventory is reduced and a claim for the purchase price arises. * * *"

In a layman's language, an accrual method means that you report income when earned, even if not received, and deduct expenses when incurred, even if not paid, within the taxable period.

In the case at bar, the partnership, in a typical case, completed the transaction of the sale of a trailer at the time the down payment was made, either in cash or trade-in allowance, or both, and the purchaser executed and delivered to it notes and a chattel mortgage or conditional sales contract. The partnership thus acquired a complete enforceable right to receive the remainder of the purchase price at the times specified in the retail paper. The circumstance that the partnership was or was not financially able to retain the paper and collect it as it became due

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[9] Amendment XVI of the Constitution of the United States.

does not preclude the fact that its entire profit on the transaction *accrued* at that time regardless of when received. Therefore, no portion of the profit is rendered nontaxable at that time by the subsequent act of the partnership in selling the retail paper to a finance company in a transaction which left a part of the sales price of the paper temporarily retained as security by the finance company. It is significant and consistent with the law that the finance companies did not take into income the amounts credited on their books to the partnership in the dealer's reserve accounts.

Ultimately only two things could happen to the funds in the dealer's reserve accounts: either the amounts would be paid to the partnership in cash or they would be used to satisfy the partnership's other obligations to the finance companies. There is no showing that the amounts in the reserve would not be collectible from the finance companies at the appropriate time or that their collection would be improbable, for the companies were in sound financial condition and at all times able to pay out the amounts withheld in the reserves. The only thing which would prevent the partnership from receiving the full sales price would be a purchaser's default, which is not a contingency sufficient to defer the accruing of income that has already been earned. If the partnership eventually sustains such a loss, it is recognized that it would be entitled to a business deduction therefor, because it would be a debt, or portion thereof, arising from sales that had been included in income, and which was thereafter ascertained to be worthless. Actually the partnership elected, on its returns for the relevant years to use the bad debt deduction method, when it deducted for those years the amounts hereinbefore referred to. Significantly these amounts consisted in part, of advances made by the partnership to the finance companies to meet trailer purchaser's payments which the purchaser was unable to make and, after advancement, the purchaser defaulted.

Taxpayers do not seek to take advantage of 26 U.S.C.A. 23 (k) (1) of the 1939 Internal Revenue Code, insofar as a deduction, in the computation of net income, is allowed ("in the discretion of the Commissioner") for a reasonable addition to a reserve for bad debts. This position taxpayers are forced to take because of their contention that the withheld part of the sale price did not accrue to them during the relevant years. However, quite inconsistently with their argument that the withheld amounts were not accrued income to the partnership, the latter did claim, as deductions, debts included in said accounts which defaulted within the relevant years. As the court said in *Rogan* v. *Commercial Discount Co.*, 149 F.2d 585,[10] at 586:

> "At all times pertinent to this inquiry, the taxpayer was operating under the reserve method for handling bad debts and did not employ the charge-off method. The statute allows these alternative methods, but having made an election as to which method it would adopt, it could not change to the other method in the absence of the Commissioner's express permission. * * *"

It is, therefore, apparent that, although § 23 (k) (1) permits the deduction of *either*, first, specific debts which become worthless within the taxable year or, secondly, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts, the partnership chose to use the specific debt charge-off method for bad debts, and should not be allowed any deductions as a reserve for bad debts.

In *Universal Oil Products Co.* v. *Campbell*, 181 F.2d 451, (cert. denied, 340 U.S. 850, rehearing denied, 340 U.S. 894) at 470, we said:

> "Vague possibilities that income may have to be returned, or that it may possibly be subject to diminution or off-set will not alone suffice to postpone the accrual and reporting of taxable income. * * *"

[10] Cert. denied, 326 U.S. 764.

We then referred to *Helvering* v. *Nibley-Mimnaugh Lumber Company*, 63 App. D.C. 181, 70 F.2d 843, where a contract for sale of timberland was executed in 1923 and it was provided that part of the purchase price was paid in cash and the balance thereof by promissory notes secured by a mortgage. The contract further provided that taxpayer should furnish abstracts and that, for certain contingencies as to failures of title and as to there being a smaller amount of timberland than specified in the contract, there should be a reduction in the purchase price. Such reductions, if any, were to be applied against the principal of the notes. We said, at 471 of the *Universal Oil* case:

> "* * By reason of a shortage in the timberland, determined in 1924, it was agreed between the parties that more than $66,000 of the stated sale price should be deducted from the notes representing the balance of the purchase price. The Court held that if the taxpayer was reporting and paying taxes on an accrual basis, the facts shown were sufficient to accrue the entire purchase price in 1923, even though the agreed price was conditionally subject to abatement. The Court said that the right of the seller to have the notes paid, accrued in 1923, because it then became a fixed and unconditioned liability. It is significant that in that case there was, as here, a condition which provided for a proportionate reduction in the purchase price in the event of the happening of a certain contingency."

Our conclusions, therefore, were:

> "We see from these decisions that it is not every contingency that prevents the accrual of income. The contingency must be real and substantial. * * *
>
> * * * * *
>
> "* * * We must, therefore, hold that it was the duty of plaintiff to accrue and report as a part of its 1945 income the total amount of $1,035,205, which it was to receive as its share of the consideration for the license."

To the same effect are *Commissioner of Internal Revenue* v. *Union Pac. R. Co.*, 86 F.2d 637, 639; *Frost Lumber Industries* v. *Commissioner of Int. Rev.*, 128 F.2d 693, 696; and *Clark* v. *Woodward Construction Co.*, 179 F.2d 176, where the court, at 177, said: "The decisive factor is the creation of an enforceable liability."

In the case at bar, each sale was a transaction solely between the purchaser and the partnership. They agreed on the terms of sale, including the selling price, the down payment, the trade-in allowance, and the terms for deferred payments. The purchaser made his down payment to the partnership and delivered his traded-in vehicle to it, together with the executed retail papers. The purchaser went his way and the partnership kept the down payment and the traded-in vehicle. It was the decision of the partnership as to which finance company it would offer the retail paper. It had complete freedom of choice in this regard and conversely each finance company was free to take or refuse the offered paper. Transfer of the paper to a finance company resulted in the partnership receiving the balance of the purchase price, minus the withheld portion, the year of taxability of which is now the subject of this litigation. When this reserve had served its purpose, the partnership would also receive what remained in that fund.

Since the partnership used the accrual method of accounting, its entire profit from the sale should be reported when it accrued, regardless of when received.

Taxpayers contend that the partnership's "right to the amounts withheld from the purchase price of notes was so contingent during the taxable period that such amounts should not be accrued as taxable income in the years withheld by the finance companies." While it is possible that the partnership would not receive all of the amounts in cash, the parts withheld would in all events be used for the benefit of the partnership to satisfy its future obliga-

tions, if any, to the finance companies. Taxpayers confuse the arrangement with respect to *payment* of the sums in the reserve accounts with the vesting in the partnership in the relevant years of a fixed right to receive in due course definite sums which had become accruable to it at the times of sale in the relevant years. There is no uncertainty with respect to the amounts accrued during the relevant years. These amounts were definitely fixed at the time the funds were placed to the partnership's credit in the dealer's reserve accounts. Moreover, there is no showing that the amounts in the reserve accounts would not be collectible at the appropriate time or that collection would be improbable, as we have pointed out, *ante* 5. In the light of the record, it cannot logically be argued that the reserve would never be realized by the partship.

In its reply brief, the partnership, for the first time, argues that it could have obtained the benefits of reporting its income under the installment method, if it had been financially able to hold the retail paper instead of selling it to finance companies. Evidently referring to 26 U.S.C.A. § 44(a), it argues that an accrual basis taxpayer is entitled to report his installment sale profit in the taxable years that payments are actually received. However, there is no showing by taxpayers that the partnership purported, in making its returns of income, to rely on § 44 (a). Apparently the argument comes as an afterthought. It is not convincing.

Taxpayers have also called our attention to *Johnson* v. *Commissioner*, 233 F.2d 952, *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F.2d 395, and *Glover* v. *Commissioner*, 253 F.2d 735. Even if we ignore some of the facts involved in these cases which are different from those involved in the case at bar, we adhere to the views herein expressed.

We affirm the decisions of the Tax Count.

AFFIRMED.

A true Copy:
Teste:

.....
Clerk of the United States Court of Appeals for the Seventh Circuit.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

FRIDAY, JUNE 20, 1958

BEFORE

HON. ELMER J. SCHNACKENBERG, Circuit Judge
HON. W. LYNN PARKINSON, Circuit Judge
HON. CASPER PLAYY, District Judge

Petition for Review of decisions of the Tax Court of the United States.

No. 12230

CLIFTON E. BAIRD AND VIOLET L. BAIRD,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

This cause came on to be heard on the transcript of the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the Tax Court of the United States entered in this cause on October 11, 1957 be, and the same are hereby, AFFIRMED.

APPENDIX C

SUPREME COURT OF THE UNITED STATES
No. —, October Term, 1958

Clifton E. Baird and Violet L. Baird,
Petitioners

v.

Commissioner of Internal Revenue

Order Extending Time to File Petition for Writ of Certiorari

Upon Consideration of the application of counsel for petitioner(s),

It Is Ordered that the time for filing petition for writ of certiorari in the above-entitled cause be, and the same is hereby, extended to and including November 17, 1958.

/s/ Tom C. Clark
Tom C. Clark
Associate Justice of the Supreme Court of the United States.

Dated this 17th day of September, 1958.

APPENDIX D

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income." includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [as amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income

for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 42.)

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No. 512

In the Supreme Court of the United States

OCTOBER TERM, 1958

CLIFTON E. BAIRD AND VIOLET L. BAIRD, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

J. LEE RANKIN,
Solicitor General,
Department of Justice, Washington 25, D. C.

In the Supreme Court of the United States

OCTOBER TERM, 1958

No. 512

CLIFTON E. BAIRD AND VIOLET L. BAIRD, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

The question presented in this case is whether an accrual basis partnership which sells property and receives part of the gain on sales in cash and part in the form of a credit—the latter portion to be ultimately satisfied either by payment in cash or by offset against the partnership's obligations—is required to report the amount of the gain so credited (as well as the gain in cash) as income for the year in which the credit is made. The same question is presented in *Commissioner* v. *Hansen*, No. 380, this Term, and *Commissioner* v. *Glover*, No. 381, this Term, in both of which cases this Court granted certiorari on November 10, 1958. Indeed, the facts of this case appear to present the issue in even clearer focus than do the other cases. Accordingly, the Commissioner does not

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oppose the grant of certiorari and suggests that this case be consolidated for argument with the *Hansen* and *Glover* cases, *supra,* under Rule 43 (5).[1]

Respectfully submitted.

J. LEE RANKIN,
Solicitor General.

NOVEMBER 1958.

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[1] In such event, the Commissioner intends to file a single, consolidated brief in all three cases.

SUPREME COURT, U. S.
Nos. 380, 381, and 512

FILED
MAR 6 1959
JAMES R. BROWNING, Clerk

In the Supreme Court of the United States

OCTOBER TERM, 1958

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN R. HANSEN AND SHIRLEY G. HANSEN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

BURL P. GLOVER

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

CLIFTON E. BAIRD AND VIOLET L. BAIRD, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE COMMISSIONER

J. LEE RANKIN,
Solicitor General,
CHARLES K. RICE,
Assistant Attorney General,
JOSEPH F. GOETTEL,
MEYER ROTHWACKS,
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Sec. 22(a) (26 U.S.C. 1952 ed., Sec. 22(a))	60
Sec. 23(k)(1) (26 U.S.C. 1952 ed., Sec. 23(k)(1))	28
Sec. 41 (26 U.S.C. 1952 ed., Sec. 41)	30, 33, 60
Sec. 42(a) (26 U.S.C. 1952 ed., Sec. 42(a))	61

Miscellaneous:

Conner, *Taxation: Federal Income Tax: Dealers' Reserves: Time When Accruable as Income: Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395 (5th Cir. 1958), 43 Corn. L. Q. 719, 722 (vol. 4, 1958) ..... Page 58

G.C.M. 9571, X-2 Cum. Bull. 153 (1931) 28, 36, 37, 65

Hardy, *Another View On The Origin of Dealer Participation in Automobile Finance Charges*, 30 Ind. L.J. 311 (1955) 44, 45

Holland, *Accrual Problems in Tax Accounting*, 48 Mich. L. Rev. 149 (1949) 54

2 Mertens, *Federal Income Taxation* (Rev.), Secs. 12.61 and 1262 54

2 Mertens, *Federal Income Taxation* (1955), Sec. 11.19 56

Note, *Is Control of Dealer Participation A Necessary Adjunct To Regulation of Installment Sales Financing?*, 28 Ind. L.J. 641 (1953) 45

Note, *Taxation-Deferred Income-Amounts Credited To "Dealer Reserve" Account Are Income To Accrual Basis Taxpayer When Credited*, 42 Minn. L. Rev. 151, 154 (1957) 54

Pecar, *Dealer Participation In Automobile Finance Charges: A Reply*, 30 Ind. L.J. 319 (1955) 45

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Treasury Regulations 111:

Sec. 29. 41-1 ..... 30, 64

Sec. 29. 41-2 ..... 30, 64

Treasury Regulations 118:

Sec. 39.41-1 65

Sec. 39.41-2 65

Whitaker, *Accruability of Dealer Reserves Withheld by Finance Company*, 55 Mich. L. Rev. 733, 734 (1957) 48

In the Supreme Court of the United States

OCTOBER TERM, 1958

No. 380

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN R. HANSEN AND SHIRLEY G. HANSEN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 381

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

BURL P. GLOVER

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

No. 512

CLIFTON E. BAIRD AND VIOLET L. BAIRD, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE COMMISSIONER

OPINIONS BELOW

The findings of fact and memorandum opinion of the Tax Court in the *Hansen* case (H.R. 60–68),[1] are not officially reported; the opinion of the Court of Appeals for the Ninth Circuit (H.R. 86–94) is reported at 258 F. 2d 585. The findings of fact and memorandum opinion of the Tax Court in the *Glover* case (G.R. 26–32) are not officially reported; the opinion of the Court of Appeals for the Eighth Circuit (G.R. 36–40) is reported at 253 F. 2d 735. The findings of fact and memorandum opinion of the Tax Court in the *Baird* case (B.R. 43–54) are not officially reported; the opinion of the Court of Appeals for the Seventh Circuit (B.R. 74–86) is reported at 256 F. 2d 918.

JURISDICTION

The judgment of the Court of Appeals in the *Hansen* case was entered on August 4, 1958. (H.R. 95.) The judgment of the Court of Appeals in the *Glover* case was entered on April 23, 1958. (G.R. 41.) The judgment of the Court of Appeals in the *Baird* case was entered on June 20, 1958. (B.R. 87.) The time for filing the petition for a writ of certiorari in the *Glover* case was extended to and including September 20, 1958. (G.R. 42.) The time for filing the petition for a writ of certiorari in the *Baird* case was

[1] The designation "H.R." refers to the printed record in No. 380, *Commissioner of Internal Revenue* v. *John R. Hansen and Shirley G. Hansen;* the designation "G.R.", to the printed record in No. 381, *Commissioner of Internal Revenue* v. *Burl P. Glover;* and the designation "B.R.", to the printed record in No. 512, *Clifton E. Baird and Violet L. Baird* v. *Commissioner of Internal Revenue.*

extended to and including November 17, 1958. (B.R. 88.) The petitions for writs of certiorari in the *Hansen* and *Glover* cases, filed on September 18, 1958, were granted on November 10, 1958. (H.R. 96; G.R. 43.) The petition for a writ of certiorari in the *Baird* case, filed on November 12, 1958, was granted on December 15, 1958. (B.R. 88–89.) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether accrual basis taxpayers who sell property on credit and discount their customers' obligations with finance companies, realizing part of their gain in cash and part in the form of amounts credited to them—the latter portion to be ultimately satisfied either by payment in cash or by offset against the taxpayers' obligations—are required to report the amount of gain so credited (as well as the gain in cash) as income for the year in which the sales and credits are made.

STATUTE AND OTHER AUTHORITIES INVOLVED

Printed in the Appendix, *infra*, pp. 60–70, are Sections 22(a), 41 and 42(a) of the Internal Revenue Code of 1939; Rev. Rul. 57–2, 1957–1 Cum. Bull. 17; Treasury Regulations 111, Sections 29.41–1 and 29.41–2; and G.C.M. 9571.

STATEMENT

The single question in these cases is when accrual basis taxpayers shall treat as income amounts credited to reserve accounts held in their names by finance

companies with which they did business. The taxpayers sold property (principally automobiles and trailers) to customers on credit, and discounted their customers' obligations with the finance companies. The finance companies paid the taxpayers a certain amount in cash and credited them with certain additional amounts. The amounts credited were subsequently to be paid to the taxpayers in cash or used to discharge taxpayers' indebtedness to the finance companies. The Commissioner contends that the amounts credited to the taxpayers should be included in their income for the year in which the sales and credits were made. The taxpayers contend that, even though they were concededly on the accrual basis of accounting, the amounts credited to them should not be included in income until actually received by them.

Hansen, No. 380

In this case, taxpayer (and his wife, with whom he filed joint income tax returns) filed a petition in the Tax Court requesting, among other things, a redetermination of deficiencies in income tax for 1951, 1952 and 1953, in the total amount of $6,903.30. (H.R. 41.) The facts found by the Tax Court (H.R. 61–65), some of which were stipulated (H.R. 5–6), may be summarized as follows:

Taxpayer was engaged in the business of selling automobiles at retail under conditional sales contracts providing for payment of the purchase price in installments. The form of contract used, which was provided by the General Motors Acceptance Corporation (GMAC), called for a "Total Time Price" for

the automobile sold. This was computed by subtracting the down payment (including the trade-in, if any) from the "Cash Sale Delivered Price", and adding to the difference the cost of insurance and finance charges. The amount thus arrived at was called the "Time (Deferred) Balance". The down payment was added back to the "Time (Deferred) Balance" to fix the "Total Time Price". (H.R. 61.)

Taxpayer financed all of the conditional sales through GMAC. Pursuant to the terms of the endorsement contained on each contract,[2] taxpayer

[2] The form contract included the following endorsement (Stip. Ex. 5–E, H.R. 6, 39–40, 62–63):

"For value received, undersigned does hereby sell, assign and transfer to the General Motors Acceptance Corporation his, its or their right, title and interest in and to the within contract, herewith submitted for purchase by it, and the property covered thereby and authorizes said General Motors Acceptance Corporation to do every act and thing necessary to collect and discharge the same.

"The undersigned certifies that said contract arose from the sale of the within described property, warranting that title to said property was at time of sale and is now vested in the undersigned free of all liens and encumbrances; that said property is as represented to the purchaser of said property by the undersigned and that statements made by the purchaser of said property on the statement form attached hereto are true to the best of the knowledge and belief of the undersigned.

"In consideration of your purchase of the within contract, undersigned guarantees payment of the full amount remaining unpaid hereon, and covenants if default be made in payment of any installment herein to pay the full amount then unpaid to General Motors Acceptance Corporation upon demand, except as otherwise provided by the terms of the present General Motors Acceptance Corporation Retail Plan. Liability of the undersigned shall not be affected by any indulgence, compromise, settlement, extensions or variation of terms of the with-

assigned the contract to GMAC in exchange for the amount stated therein, reduced by an amount withheld and placed by GMAC in a reserve account. That account contained at least 5% of the outstanding balances on the contracts assigned to GMAC. Taxpayer was not required to assign any of the contracts to GMAC or to any other finance company, and could have held such contracts himself without assignment. (H.R. 63.)

The reserve was maintained in order to protect GMAC against any loss arising from the repossession of automobiles in the event of default in payment. Also, in the event of purchasers' prepayments, the proportionate reduction in finance charges was charged to the reserve. (H.R 63–64.)

Taxpayer's books of account were maintained, and his returns were filed, on the accrual method. Taxpayer had accounts receivable, and charged off bad debts specifically as they became worthless. The amounts GMAC placed in the dealer's reserve were debited by taxpayer to an account entitled "Due Finance Company", and credited to an account entitled "Reserve for Repossession". Taxpayer did not report any of the amounts credited to him in the reserve account in 1951 and 1953 as income for those years.[3] He did, however, report amounts retained in

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in contract effected with, or by the discharge or release of the obligation of the purchaser or any other person interested, by operation of law or otherwise. Undersigned waives notice of acceptance of this guaranty and notices of non-payment and non-performance."

[3] Taxpayer's 1952 return reported as income the amount of $4,462.27, which GMAC had credited to him in that year in

the reserve account as income in the years when such amounts were paid to him by GMAC. (H.R. 64.)

The Tax Court, sustaining the Commissioner's deficiency determination, held that the amounts credited to taxpayer by GMAC were a part of his gross income in the years in which the credits were made. (H.R. 64–65.) The Court of Appeals reversed the Tax Court's decision on that phase of the case.[4] (H.R. 95.)

Glover, No. 381

In this case, taxpayer filed a petition in the Tax Court requesting, among other things, a redetermination of deficiencies for 1949, 1950 and 1951, in the total amount of $9,002.31. (G.R. 2.) The facts, as stipulated (G.R. 20–25), and as found by the Tax Court (G.R. 26–32), may be summarized as follows:

Taxpayer, operating under the trade name of Glover Motors, was engaged in the business of selling motor vehicles. He kept his books, and (with his wife) filed joint income tax returns for the relevant years, on the accrual basis. (G.R. 27, 38.)

Taxpayer sold cars on credit, receiving notes for the balances due on the purchase price. Pursuant to a written contract prepared by the Universal C.I.T. Credit Corporation (C.I.T.), taxpayer sold and transferred the notes to that company. Certain classes of the notes were transferred without recourse; others

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the reserve account. Taxpayer included the same amount in 1953 income, thus necessitating an adjustment of income for that year. (H.R. 72.)

[4] A penalty issue determined below (H.R. 65–67) is not before this Court.

were transferred with full recourse. (G.R. 27, 37.)

On transfer and delivery of the notes, C.I.T. paid the taxpayer a certain percentage of their face value. A smaller percentage withheld was evidenced on C.I.T.'s books by entry in a so-called dealer's reserve account. Corresponding entries were made on taxpayer's books. (G.R. 20, 37.)

Under its agreement with C.I.T.,[5] taxpayer was obligated, among other things, to repurchase repossessed cars for the unpaid balance due on the notes;

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[5] The agreement, in full, provided as follows (G.R. 27–29):

"*To Universal C.I.T. Credit Corporation:*

"1. You propose to buy from us, on the basis stated in this agreement, paper acceptable to you covering new and used cars; except as provided in this agreement said paper will be assigned to you without recourse as to the customer's obligation of payment, except that paper covering commercial cars used for long distance hauling, commercial cars of more than two tons capacity, busses, cars used for taxi, jitney, "drive yourself" service, or cars sold to relatives or employees will bear our full recourse endorsement; in such cases you may make any necessary correction in our endorsement and paragraphs 2 and 3 shall not apply.

"2. We will purchase from you each repossessed or recovered car tendered at our place of business within 90 days after maturity of the earliest installment still unpaid. The purchase price payable on demand shall be the unpaid balance due on the car, limited as stated in paragraph 3. Until paying you we will store the car at our risk and expense and as your property and will deliver it to you on demand.

"3. We shall have no responsibility as to converted or confiscated cars until they are repossessed or recovered and tendered as above. You will allow us the cost of repairing actual direct collision damage necessitating repossession; the allowance is not to exceed the unpaid balance on the car after deducting both the "as is" value and the amount of any deferred certificate or other special holdback relating to the car. Where the resale value of the repaired car (excluding overhead and

he was also responsible for any deficiency incurred by the finance company in the resale of repossessed cars. C.I.T. was obligated to pay to taxpayer—three times in each twelve months period if taxpayer was not then indebted to it—the accumulated reserves in excess of three percent of the total unpaid balance on

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salesman's commissions) exceeds the unpaid balance, the excess will be deducted from the collision allowance.

"4. Your rate charts will include, for our protection, reserves as outlined in your reserve arrangement effective at the time paper is purchased by you. No reserves are to be set up in respect of short term note, demonstrator or other special plans announced by you from time to time, except as may be agreed upon hereafter in writing. Three times in each twelve-month period, if we are not then indebted to you, you will pay us our accumulated reserves in excess of 3% of the then aggregate unpaid balances on paper purchased from us. If you stop buying our paper, you may hold and apply all reserves until liquidation of all paper purchased from us is completed.

"5. If you refund any part of the service charge because an account is prepaid, we agree to pay you the same percentage of all reserves credited to or paid us on the account as the amount of service refund bears to the amount of the original charge exclusive of insurance premium.

"6. If, in reselling repossessed passenger cars which we purchase from you, covered by paper sold to you in any twelve-successive-month period, we incur a loss (excluding overhead and salesman's commissions) in excess of 3% of the volume of our paper sold you during said period, plus the amount of our reserves for said period, you shall reimburse us for such excess, provided we have resold the cars for their reasonable value within 90 days after delivery to us. We shall credit total profits on resales against total net losses. This paragraph applies only (a) if we have sold you paper covering at least 100 cars during such period, (b) if we perform all of our obligations to you, and (c) if, before incurring such excess losses, we give you written notice of the offered price of each car and the opportunity to resell it.

"7. We will be under full recourse liability to you on the assignment of paper covering equipment other than described

the notes. If C.I.T. stopped purchasing notes from taxpayer, it (C.I.T.) was entitled, under the contract, to hold and apply all reserves against taxpayer's indebtedness to it, until liquidation of all the paper was completed. If C.I.T. became obligated to refund any part of the service charge to a purchaser, the contract provided that taxpayer would pay to C.I.T. the same percentage of all reserves credited or paid

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in paragraph 1 above notwithstanding the language of such assignment, or if in connection with any transaction covering equipment described in paragraph 1 we make any settlement with a customer without your written consent, if we disclose any part of this agreement to the customer, if we breach any provision of the assignment to you, and on paper which bears or in connection with which you receive our guaranty. In any such cases you may make any necessary changes in our endorsements or assignments to express such liability. If we are in default to you under this or any other agreement or obligation at the time of any repossession, cars may be tendered by registered mail notice sent to the last address known by your records, instead of as provided in paragraphs 2 and 3 above; if we are not then doing business as a going concern, tender of repossessed cars is waived. In case we fail to purchase repossessed cars we will be responsible for any deficiency incurred by you in the resale of such repossessed cars at public or private sale held with or without notice, at which you may purchase.

"8. This agreement shall apply to all paper hereafter sold to you as above stated, irrespective of transfers between or extensions of time to customers and until the paper is liquidated, unless otherwise specifically agreed in writing with respect to the particular paper. No waiver or change of any part of this agreement shall be binding on you unless evidenced by writing signed by one of your officers.

"9. The purchase of paper by you from us shall constitute acceptance by you of this agreement, which shall cover all such purchases. This agreement shall inure to and bind our respective successors and assigns and any present and future company affiliated with you which may transact business hereunder."

to it on the account as the amount of the refund bore to the original charge, exclusive of insurance premium. (G.R. 28–29, 37.)

The following amounts, representing three percent of customers' notes outstanding, were reflected in the dealer's reserve account at the end of the indicated years, but were not reported as income by taxpayer: 1949—$3,885.71; 1950—$7,601.07; 1951—$7,952.41. (G.R. 30–31, 37.) The Commissioner determined deficiencies by including the amounts in income in the respective years in which they were credited to the reserve account. (G.R. 31, 37.) The Tax Court sustained the deficiencies. (G.R. 32–33.) On appeal, the Court of Appeals reversed. (G.R. 41.)

Baird, No. 512

In this case, taxpayers, husband and wife, doing business as equal partners under the name of Baird Trailer Sales, filed petitions in the Tax Court requesting redetermination of income tax deficiencies for the calendar years 1952, 1953, and 1954, aggregating $47,020.60. (B.R. 57.) The deficiencies resulted from the Commissioner's action in treating as partnership income for the fiscal years ended February 28, 1952, 1953, and 1954 amounts credited in those years (in the name of the partnership) to so-called dealers' reserve accounts maintained by finance companies to which the partnership had sold the notes, chattel mortgages and unconditional sales contracts of its vendees. (B.R. 24–25.) The facts, as stipulated (B.R. 13–22) and as found below (B.R. 44–54; 75–79), may be summarized as follows:

Taxpayers filed joint returns on a cash basis for the calendar years involved. The partnership, which since its organization in January 1947 had been engaged in the sale of new and used mobile homes, or house trailers, and to a lesser extent in new and used cars, parts and accessories, furniture, and real estate, kept its books and filed its income tax returns on the accrual basis. Partnership returns were filed for the fiscal years ended February 28, 1952, 1953, and 1954, and an amended return was filed for the fiscal year ended February 28, 1952. (B.R. 44.)

During the taxable years, the partnership sold, to either of two finance companies [6] or a bank [7] (collectively referred to as finance companies), unpaid notes, chattel mortgages and conditional sales contracts (collectively referred to as retail paper). The proceeds of such sales were paid by the finance companies to the partnership, with this exception: a part was withheld by each finance company and credited to the dealer's reserve account of the partnership on the finance company's books.[8] The partnership either endorsed with recourse the retail paper sold to the finance companies, or guaranteed its payment. (B.R. 75–76.) It was agreed between the partnership and

[6] Minnehoma Financial Company of Tulsa, Oklahoma (referred to as Minnehoma); Midland Trailer Finance Corporation (referred to as Midland). (B.R. 44.)

[7] Michigan National Bank of Grand Rapids, Michigan (referred to as Michigan). (B.R. 44.)

[8] The part withheld by Michigan was deposited in an account designated "dealer escrow account" in the name of the partnership. (B.R. 50.)

the finance companies, either orally or in writing, that (B.R. 76):

> (a) In the event the retail paper became due and unpaid, the finance company could charge the dealer's reserve with the unpaid balance;
>
> (b) In the event the partnership had a matured financial obligation of any nature to the finance companies, the amount of such obligation could be charged to the dealer's reserve account;
>
> (c) Repossession losses of the finance companies could be charged to the dealer's reserve account;
>
> (d) The ultimate balance in the dealer's reserve account after payment of all notes by the partnership to the finance companies was to be paid to the partnership; and
>
> (e) Each finance company could look to the balance in the dealer's reserve account to satisfy any default by the partnership on its guaranties and obligations to the finance company, as well as any default by the makers of the notes.

Under the terms of the separate agreements with Minnehoma, Michigan, and Midland,[9] the partnership

[9] The record shows the following written agreements entered into between taxpayers and the finance companies:

The agreement with Minnehoma. The partnership and Minnehoma signed a document, dated December 30, 1949, relating only to new trailer coaches manufactured by the Spartan Aircraft Company, entitled "Agreement Covering Purchase of Conditional Sales Contract". Among other things, it provided, as follows (B.R. 45–46):

"1. The Dealer shall not be obligated to sell any conditional sales contracts to Minnehoma, but may offer Minnehoma such contracts as the Dealer may from time to time choose, and

sold most of its trailer notes for the deferred purchase price of the trailers, plus, in certain cases, a percentage of the interest or finance charges. As each note was transferred to it with recourse, the finance company remitted to the partnership the amount due it on the selling price of the trailer as above described, less an amount which was credited on

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Minnehoma shall not be obligated to purchase or acquire any contracts offered for sale and assignment by the Dealer, but shall purchase only such contracts as it is willing to do. This agreement shall govern only the sale and assignment of such conditional sales contracts as the Dealer shall elect to sell and Minnehoma shall indicate its willingness to purchase and acquire.

* * * * * *

"6. The purchase price of each conditional sale contract purchased by and assigned to Minnehoma hereunder shall be equal to the retail cash sales price of the trailer coach and all extra equipment plus all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance.

"7. The Dealer unconditionally guarantees the payment of all sums required to be paid under each conditional sale contract purchased by and assigned to Minnehoma hereunder when such payment shall become due. In the event that the purchaser defaults or fails to pay any installment due under any conditional sale contract purchased by and assigned to Minnehoma hereunder, the Dealer agrees to demand of Minnehoma to pay such sum then due or, upon request of Minnehoma, to re-purchase from Minnehoma for the entire balance remaining unpaid under said conditional sale contract. * * *"

There was no provision in the 1949 agreement for the withholding of any dealer reserve by Minnehoma. (B.R. 46.)

On November 8, 1950, the aforementioned December 30, 1949, agreement with Minnehoma was superseded by an "Agreement Covering Purchase of Conditional Sales and Other Time Sales Contracts", paragraphs 6 and 7 of which provided as follows (B.R. 46-47):

its books to an account in the name of the partnership (designated "Dealer Reserve Account" by Minnehoma and Midland, and "Dealer Escrow Account" by Michigan). The amount withheld and credited to such account was usually 5 percent of the unpaid balance on each note, though in some cases the figure was 3 percent. In certain instances, Minnehoma and Mid-

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"6. The purchase price of each contract purchased by and assigned to Minnehoma hereunder shall be equal to 95% of the aggregate of the retail cash sales price of the trailercoach and all extra equipment and all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance.

"7. An amount to be determined by Minnehoma from time to time in its absolute discretion equal to not more than 5% of the aggregate of the retail cash sales price of the trailercoach and all extra equipment and all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance will be credited by Minnehoma to a special reserve account in the name of the Dealer hereunder as to each contract purchased by and assigned to Minnehoma hereunder, which account will be referred to as the "Dealer Reserve Account". In addition, Minnehoma may credit to such Dealer Reserve Account hereunder, but shall not be obligated so to do, one-fifth (1/5) on new trailers and one-sixth (1/6) on used trailers, or such other portions as Minnehoma may determine from time to time, of the finance charge paid or agreed to be paid by the purchaser in each contract. In addition to and without affecting any or all of its rights hereunder, Minnehoma may, at its option, charge against the Dealer Reserve Account any sums that the Dealer may at any time owe to Minnehoma in any connection whatsoever. In the event and at such time or times as the Dealer Reserve Account shall exceed 15% of the aggregate unpaid balances of all contracts purchased by and assigned to Minnehoma hereunder by the Dealer plus all contingent liabilities which, on the sole determination of Minne-

land also credited to the partnership's account a portion of the finance charge. At the time of sale, the finance companies sent the partnership a memorandum of the amount thus withheld and credited. The partnership also received periodic statements of the balances in the accounts. (B.R. 49–50.)

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homa, it may have with respect to such contracts, Minnehoma will pay such excess to the Dealers from time to time as determined by Minnehoma but not more frequently than once each month. In the event that and at such time as all contracts as shall have been purchased and assigned to Minnehoma by the Dealer shall have been paid in full and no sums shall remain unpaid thereunder and in the opinion of Minnehoma there shall be no contingent liability on the part of Minnehoma with relation thereto, Minnehoma shall pay to the Dealer the balance of the credit in such Dealer Reserve Account. Minnehoma's determination as to the possibility of contingent liability shall be final and not subject to question by the Dealer."

Credits to the dealer reserve account, in amounts usually five percent of the aggregate retail cash sales price of the trailer, were entered on the books of Minnehoma. The 1950 agreement, as did the December 30, 1949 agreement, provided that the dealer-partnership "unconditionally guarantees the payment of all sums required to be paid under each contract purchased by and assigned to Minnehoma hereunder when such payment shall become due". (B.R. 47.)

On December 21, 1950, the amount of finance charge that Minnehoma had been crediting to the partnership's reserve account was changed from one-fifth to one-tenth on new trailers, and from one-sixth to one-twelfth on used trailers, effective January 1, 1951. (B.R. 47.)

The agreement with Michigan. The written portion of the agreement between the partnership and Michigan is contained in a "Collateral Assignment", providing, in part, as follows (B.R. 47–48):

"For Valuable Consideration, the receipt of which is hereby acknowledged, the undersigned hereby sells, assigns, transfers, and conveys unto Michigan National Bank, of Grand Rapids, Michigan, its successors, and assigns forever irrevocably, all of

The partnership was not required by any finance company to do business with it to the exclusion of any other company. The partnership was not financially

his, its, or their right, title and interest in certain sums of money now on deposit or that may hereafter be deposited in the Michigan National Bank, of Grand Rapids, Michigan, and identified and represented by Reserve account in the name of the undersigned in the Michigan National Bank.

"This Assignment and Transfer is made as collateral security for the payment of the direct and indirect liability of the undersigned to the said Michigan National Bank of Grand Rapids, Michigan, and to secure the payment of the several notes representing said direct and indirect liability and any renewal or renewals thereof, or any installment payment or payments and to secure any obligation which may arise which the undersigned may owe to said Michigan National Bank of Grand Rapids, Michigan.

"In the event of default in the payment of said liability or any installment thereof, or any of the several notes at the time when same shall fall due or in the payment of the interest thereon or any part of the principal of said liability then the Michigan National Bank, of Grand Rapids, Michigan, at their election, notice of said election being hereby expressly waived, may apply the total of said sums of money represented by said Reserve account at the date of election or any part thereof to meet the default in the liability.

"Whenever the indebtedness secured hereby is paid in full the Michigan National Bank, of Grand Rapids, Michigan, shall reassign said sums of money represented by said Reserve account along with all right, title and interest back to the undersigned.

"If in the opinion of the bank the undersigned dealer's account is in good standing, all sums in this reserve account in excess of ten per cent (10%) of the gross unpaid balance of all contracts outstanding on February 28 of each year will promptly be returned to the undersigned dealer."

The above agreement did not contain the provisions by which amounts representing a percentage of the aggregate sales price of the trailers, or amounts representing a percentage of the

able to carry the contracts of sale or the floor plan [10] and, at the same time, to carry the inventory of trailers held for sale. It accordingly relied upon the finance companies. For its own convenience, it procured and used in its sales legal forms furnished by the finance companies. (B.R. 76.)

The dealer's reserve account on each finance company's books was reflected as a liability of the finance

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finance charge, were credited to the partnership's account on the finance company's books. (B.R. 49.)

The agreement with Midland. The written portion of the original agreement between the partnership and Midland is embodied in two letters, written by Midland, dated December 3 and 18, 1951, containing, in part, the following (B.R. 49):

"* * * The retail paper is to be endorsed by you with recourse.

"Our advance on new trailer paper will be 97% on the unpaid cash balance and on used trailer paper, for 95% on the unpaid cash balance. The differentials of 3% and 5% will accumulate to provide you with a loss reserve. When this reserve fund exceeds 10% of your outstandings, the excess will be paid to you automatically."

On and after June 10, 1952, the partnership notes were sold to Midland under the terms of a letter from Midland dated June 4, 1952, providing, in part, as follows (B.R. 49):

"Beginning on June 10, we will set up a dealer profit reserve equal to 1% of the unpaid cash balance of each retail contract. This profit reserve will be derived from the service charge and it will be paid to the dealer when the retail contract is paid out.

"Effective also on June 10, the dealer reserves of 3% on new transactions and 5% on used transactions, will be paid to the dealer when the contract is paid out. This procedure will be followed on all types of payoffs, including payment by the purchaser at maturity, anticipation by the purchaser or payment by the dealer in the cases of trade-ins or repossessions."

[10] This is the term used to describe loans made by a finance company to a dealer in order to finance the dealer's purchase of stock-in-trade. See *Shoemaker-Nash, Inc.* v. *Commissioner*, 41 B.T.A. 417, 420.

company, and the annual balances in such account were not reflected in its income. (B.R. 51.)

The following illustrates a typical trailer sales transaction (B.R. 18):

Sales Price of Trailer	$5,545.00
Cash Down Payment (and/or Trade-in Allowance)	1,745.00
Balance Due Baird Trailer Sales	3,800.00
VSI (Skip Insurance), Credit Check, Insurance	420.00
Principal (Amount of Note)	4,220.00
Financing Charges Paid to Finance Company	1,265.80
Balance Due Baird Trailer Sales	3,800.00
Credited to Reserve of Baird Trailer Sales	190.00
Cash Paid Baird Trailer Sales by Finance Co.	$3,610.00

Prior to receipt of the remittance from the finance company, such a transaction was recorded on the books and records of the partnership as follows (B.R. 18, 51):

Sales Receipt Journal Entry

Cash and/or Trade-in Allowance	$1,745.00	
Contracts Receivable—Finance Company	3,800.00	
Trailer Sales		$5,545.00

When the finance company remitted to the partnership, the following entries were made (B.R. 18, 51–52):

Reserve—Finance Company	$190.00	
Cash	*3,632.67	
Expense for Intangible Stamps	1.38	
Contracts Receivable		$3,800.00
Expenses (Credit Check)		24.05
		3,824.05
Cost of Sales	3,824.05	
Credit Inventory		3,824.05

*It may be noted that the amount in excess of $3,610 debited to cash ($22.67), when added to the amount debited to expense ($1.38), equals the total amount credited to expense ($24.05).

When a purchaser defaulted on his contract and note, the trailer was repossessed upon receipt of notice of default. The partnership always paid the finance company the unpaid balance due on such note, and recorded such payment on its books and tax returns as a purchase. Where defaults occurred on the notes payable to the partnership, the payments made to the finance companies as a result of the defaults were included in the partnership's returns for the taxable years as a part of cost of goods sold. On resale of the repossessed trailer, the receipts therefrom were reported as gross receipts.[11] (R. 52.)

[11] For example, if a trailer costing $5,545, with notes payable outstanding of $3,500, was repossessed, and the trailer's fair market value was only $3,000, the loss, if any, was reflected on the partnership's books and records as part of cost of goods as follows: The bookkeeper of the partnership, either on the date of repossession or at the close of the fiscal year, charged $500 to overallowance on trailers, and recorded the purchase price of the trailer in cost of used trailers at $3,000 (its fair market value). However, if the trailer was sold during the fiscal year in which it was repossessed, and the bookkeeper had not charged $500 to overallowance on trailers, the purchase price of the trailer was reflected in cost of used trailers at $3,500, and the sales price of $3,000 was reported in gross receipts. In the event the notes payable outstanding were $3,000 or less in the above example, the purchase price of the trailer was reflected in cost of used trailers at the amount paid by the partnership on the unpaid balance of the note payable. The finance company remitted to the partnership the amount which had been credited to the account designated "Dealer's Reserve" with respect to such defaulted contract and note, and the partnership reported such amount in taxable income for the year of receipt, except that for the years 1947 and 1948, the credits to the "Dealer's Reserve" were included in taxable income. (B.R. 52–53.)

The following table shows the amounts credited on the books of Minnehoma, Michigan, and Midland to the dealer reserve accounts of the partnership, and the amounts which the partnership received out of such accounts from those companies and from other finance companies in the years indicated (B.R. 53):

Fiscal year ended February 28	Credited by Minnehoma, Michigan, and Midland in dealer reserve accounts of partnership	Received by partnership from all finance companies
1952	$25,816.58	$1,217.94
1953	29,560.54	1,778.94
1954	29,660.49	9,141.39

On its returns for the taxable years, the partnership deducted specific bad debts in the respective amounts of $1,203.75, $2,239.12, and $1,203.69. The deductions, in part, reflected unpaid amounts due the partnership for accessories, supplies and repairs. They also reflected purchasers' defaults with respect to advances made by the partnership to enable the purchasers to meet trailer payments. (B.R. 53.)

No delinquent notes were charged to the dealers' reserve accounts. During the taxable years the finance companies were in such good financial condition that they were able to pay any accounts which might have been due and payable to the partnership out of the reserve accounts. (B.R. 79.)

In computing the gross receipts reported in its returns for the taxable years, the partnership deducted from gross sales the total amount credited by the finance companies in each year to the dealers' reserve accounts. The Commissioner included such

amounts in the partnership's income. In determining the contested deficiencies, the Commissioner reduced the total amounts credited by the finance companies to the dealers' reserve accounts by the amounts which the partnership received from the finance companies in the taxable years, and added the net amounts to the partnership's income. (B.R. 53–54.)

The Tax Court held that the amounts credited to the partnership in the dealers' reserve accounts were includible in taxpayer's income in the years in which the credits were made. The Court of Appeals affirmed the decisions of the Tax Court. (B.R. 54, 87.)

SUMMARY OF ARGUMENT

Taxpayers in all three cases before the Court are on the accrual basis. All are dealers who sold automobiles and trailers to customers on credit for what is generally designated as a time purchase price (representing the difference between the total purchase price, including finance and other charges, and the amount paid by the customer in cash, plus the trade-in allowance, if any). Taxpayers did not retain their vendees' notes (or other commercial paper). Instead, they discounted their customers' obligations with finance companies. The dealers thereupon received the major part of the consideration paid by the finance companies in cash. The balance of the consideration was credited to them in so-called dealers' reserve accounts. It is the taxability of the amounts so credited which is here in issue.

There can be no doubt that taxpayers on the accrual basis must report in a given year (the annual

accounting period) all income which they have acquired a fixed right to receive in that year, even though actual receipt may be deferred. It is equally settled that the right to receive income is deemed fixed even though there is a possibility—a normal business risk—that the income (or a portion of it) may prove uncollectible. In the absence of abnormal contingencies which make the possibility of payment remote, the creditor must, as of course, accrue the debtor's obligation—a procedure which is the very essence of accrual accounting.[12] The ordinary rules govern the instant cases.

The very types of credit here involved—credits held by automobile finance companies for automobile dealers in so-called dealers' reserve accounts—have been the subject of administrative pronouncement and practice since 1931. Consistently, such credits have been treated as income which has accrued to the dealer in whose favor the credit stands. Regularly, since 1940, when it first dealt with the issue, the Tax Court has taken the same view. During the 27-year period in which the administrative practice has been regularly maintained, Congress has made

[12] A taxpayer on the accrual basis is, of course, entitled to appropriate deductions for bad debts. He must either claim such deductions specifically, or, in appropriate circumstances, elect to employ reserves for bad debts. There is no issue as to deductions before the Court. Indeed, the records in these cases show that taxpayers specifically charged off bad debts; they did not elect to set up reserves for bad debts. If bad debt reserves were to be established in the future, they would have to be justified by demonstrated past experience as to the rate and magnitude of debtors' delinquencies.

two complete revisions of the Internal Revenue Code. It has not seen fit to make any change in the law.

Analytically, two typical transactions are involved. The first is the sale of an automobile by the dealer to the purchaser, accompanied by the execution of a promissory note by the purchaser, payable to the dealer. If matters stopped there—if the dealer retained the commercial paper, as in each instance he had every right to do—there could be no question raised as to the accrual of income. The situation would be like that of every commercial seller who offers goods or services on credit and receives a promise of payment, whether express or implied; an obligation then and there accrues.

The second transaction is the assignment of the commercial paper by the automobile dealer to a finance company, ordinarily accompanied by some undertaking on the part of the dealer in the event of delinquency by the automobile purchaser. However, this nowise affects the conclusion that the taxpayer accrued his gain immediately upon the completion of the sale. Certainly, a business man who goes to a bank or lending agency and assigns or pledges accounts receivable in order to obtain working capital does not thereby dissipate the accrued income represented by those accounts receivable.

Those Courts of Appeals which have ruled against the Commissioner's position have proceeded upon the assumption that there are not in truth two transactions, but, rather, a single three-cornered transaction. The suggestion is that the working relationship between the dealers and the finance companies is so

close that, realistically speaking, the dealer sells to the automobile purchaser but receives his payment through the finance company (a suggestion made in the face of the fact that none of the dealers was under any obligation to deal with any of the finance companies involved). These courts then take the view that such amounts as are not immediately paid by the finance company to the dealer in cash, *i.e.*, the amounts credited to him in the dealers' reserve accounts, are contingent liabilities which do not accrue until payment is made.

But even if one would be justified, contrary to our view, in ignoring the two discrete legal transactions involved, there is no sound basis, we submit, for the result reached by the courts which have adopted the "single-transaction" approach. The fact is that the dealer who works with or through a finance company has not thereby added to the risks or contingencies upon which his receiving full payment depends. The risk that he may not ultimately receive all of the monies credited to him in the dealers' reserve account turns on the possibility that automobile purchasers may default and the repossessed value of the cars may prove insufficient to satisfy the balance due from the purchasers. This is precisely the same risk as is taken by every person who sells on credit. Neither sound analysis nor consideration of the practical realities justifies the conclusion that the interposition of the finance company makes a change in the dealer's tax liabilities.[8] With or without a finance company in the picture, we submit that the dealer's gain accrues when the sale is completed, at which time

the obligation of the automobile buyer is fixed and the amount of income derived by the dealer becomes determinate.

ARGUMENT

The amounts credited to taxpayers, like the rest of the gain from sales of their property, were accruable as income for the year in which the sales and credits were made

These three cases involve accrual basis taxpayers (automobile and trailer dealers) who sold property to customers on credit and discounted their customers' credit obligations with finance companies. Since the customers' duty to pay the entire purchase price became fixed upon sale of the property, it is apparently undisputed that the taxpayers would have been required to accrue their entire gain upon consummation of such sales if they had retained their customers' credit obligations. In that circumstance, they could not have delayed accrual of any part of their gain from the sales merely because actual payment of the balance of the purchase price was to be postponed and customers might subsequently default in their payments.

Nor, we submit, are the taxpayers afforded any basis for deferring part of their gain because of the interposition of the finance companies. The finance companies acquired—necessarily from the taxpayers who sold the property—the customers' absolute obligations to pay the balance of the purchase price of such property and the dealers' contingent obligations to make good any losses which the finance companies

might subsequently suffer upon customers' defaults. The reciprocal consideration moving from the finance companies to the taxpayers was twofold—the payment of a certain amount in cash and the credit of a certain additional amount to the dealers' accounts (the so-called "dealers' reserves"). The finance companies treated the amount credited to such reserves as their liability to the dealers. Once any amount was credited to a dealer's reserve, only one of two dispositions could be made of it—(1) it would be subsequently paid to the dealer in cash, or (2) it would subsequently be used to discharge the dealer's indebtedness to the finance company. The latter alternative is no different from the receipt of cash so far as the accrual of income is concerned. Once the right to income becomes fixed, it has accrued, even though actual payment is postponed.

Consistently with this view, the Court of Appeals for the Seventh Circuit, in *Baird* v. *Commissioner* (B.R. 74–86), No. 512, concluded that the dealer's right to receive the amounts credited to its favor in the reserve accounts became fixed, even though actual payment was deferred, when the credits were made; that, in any event, the right to the full time price (which would include the amounts reflected in the dealer's reserves) became fixed when that amount had been agreed upon between the dealer and its vendees, and the retail paper had been executed in favor of the dealer; and that, consequently, there was an accrual

of income in the year when the sales and the credits to the reserve accounts were made.[13]

This view, which follows the consistent administrative practice (Rev. Rul. 57–2, 1957–1, Cum. Bull. 17 (Appendix, *infra*, pp. 61–64); G.C.M. 9571, X–2 Cum. Bull. 153 (1931) (Appendix, *infra*, pp. 65–70)), has been espoused for more than seventeen years by the Tax

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[13] There is no deduction question before this Court. Of course, as the Court of Appeals noted in *Baird* (B.R. 82–83), an accrual basis taxpayer may take appropriate specific deductions, and, indeed, in the *Baird* case "Actually the partnership elected, on its returns for the relevant years to use the bad debt deduction method". So, too, in *Hansen*, "Taxpayer used a specific charge-off account for bad debts arising from the business". (H.R. 87.) And in *Glover* the record shows that the taxpayer deducted bad debt expenses of some $1800 for 1949, $7300 for 1950, and $4100 for 1951. (G.R. 31.) To the extent that their business experience warranted, taxpayers might have elected to set up a reserve for bad debts under Section 23(k)(1) of the Internal Revenue Code of 1939. They did not do so but chose instead to use the specific charge-off method. In any event, they do not claim that the amounts credited to them by the finance companies constituted deductible bad debt reserves. Rather, they are contending that those amounts are not income. Moreover, they have never purported to demonstrate that the amounts credited to them in the dealers' reserve accounts in each of the years involved constituted, in the terms of the statute, "(in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts". Absent a showing of a correspondence between the rate of delinquency on the part of their vendees and the amounts set aside in the dealers' reserve accounts, any claimed deductions for a reasonable addition to a reserve for bad debts based on the credits to the dealers' reserve accounts would have to be denied as artificially grounded. Cf. *Automobile Club* v. *Commissioner*, 353 U.S. 180, 189.

Court [14] and has been adopted by the Sixth Circuit

[14] *Shoemaker-Nash, Inc.* v. *Commissioner*, 41 B.T.A. 417 (1940); *Colorado Motor Car Co.* v. *Commissioner*, decided March 25, 1940 (1940 P-H B.T.A. Memorandum Decisions, par. 40,178); *Royal Motors, Inc.* v. *Commissioner*, decided July 12, 1945 (1945 P-H T.C. Memorandum Decisions, par. 45,255); *Town Motors, Inc.* v. *Commissioner*, decided July 24, 1946 (1946 P-H T.C. Memorandum Decisions, par. 46,173); *Ray Woods Used Cars, Inc.* v. *Commissioner*, decided September 30, 1952 (1952 P-H T.C. Memorandum Decisions, par. 52,290); *Central Motors, Inc.* v. *Commissioner*, decided August 12, 1954 (1954 P-H T.C. Memorandum Decisions, par. 54,228); *Koch Motors* v. *Commissioner*, decided December 30, 1955 (1955 P-H T.C. Memorandum Decisions, par. 55,334); *Johnson* v. *Commissioner*, 25 T.C. 123 (1955), reversed, 233 F. 2d 952 (C.A. 4th); *Brodsky* v. *Commissioner*, 27 T.C. 216 (1956); *Texas Trailercoach, Inc.* v. *Commissioner*, 27 T.C. 575 (1956), reversed, 251 F. 2d 395 (C.A. 5th); *West Pontiac, Inc.* v. *Commissioner*, 27 T.C. 749 (1957), reversed, 257 F. 2d 810 (C.A. 5th); *Morgan* v. *Commissioner*, 29 T.C. 63 (1957), pending on appeal (C.A. 9th); *Kilborn* v. *Commissioner*, 29 T.C. 102 (1957), affirmed (C.A. 5th), September 18, 1958 (2 A.F.T.R. 2d 5812), petition for writ of certiorari pending; *Glover* v. *Commissioner*, decided March 18, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,045), reversed, 253 F. 2d 735 (C.A. 8th); *Schaeffer* v. *Commissioner*, decided April 30, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,068), affirmed, 258 F. 2d 861 (C.A. 6th); *Hansen* v. *Commissioner*, decided June 28, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,113), reversed, 258 F. 2d 585 (C.A. 9th); *Baird* v. *Commissioner*, decided October 9, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,192), affirmed, 256 F. 2d 918 (C.A. 7th); *Wiley* v. *Commissioner*, decided December 23, 1957 (1958 P-H T.C. Memorandum Decisions, par. 52,236, pending on appeal (C.A. 6th). See also, *Key Homes, Inc.* v. *Commissioner*, 30 T.C. 109 (1958) pending on appeal (C.A. 6th). Cf. *Beaudry* v. *Commissioner*, decided February 14, 1941 (1941 P-H B.T.A. Memorandum Decisions, par. 41,114), where the Board of Tax Appeals apparently concluded that the dealer did not have the right to receive, either periodically *or ultimately*, any portion of the reserve not in excess of a certain percentage of the total notes outstanding.

(*Schaeffer* v. *Commissioner*, 258 F. 2d 861 (C.A. 6th)). Contrary results have been reached, however, in the *Hansen* and *Glover* cases, Nos. 380, 381, decided by the Ninth and Eighth Circuits, respectively, and by two other circuits. See the decisions of the Court of Appeals for the Fourth Circuit in *United States* v. *Colonial Chevrolet Corp.*, affirming, January 5, 1959, the judgment of the District Court for the Eastern District of Virginia, 2 A.F.T.R. 2d 5704, *United States* v. *Marine Chevrolet Co.*, affirming, on December 12, 1958, on stipulation, 161 F. Supp. 62 (E.D.N.C.); *Johnson* v. *Commissioner*, 233 F. 2d 952 (C.A. 4th); and the decisions of the Court of Appeals for the Fifth Circuit in *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395; *West Pontiac, Inc.* v. *Commissioner*, 257 F. 2d 810; *United States* v. *Hines Pontiac*, decided September 6, 1958 (2 A.F.T.R. 5694); *United States* v. *Modern Olds, Inc.*, decided September 15, 1958 (2 A.F.T.R. 2d 5713); and *Kilborn* v. *Commissioner*, decided September 18, 1958 (2 A.F.T.R. 2d 5812).

I. The applicable principles

A. *The fixed right to receive*

Section 41 of the Internal Revenue Code of 1939 (Appendix, *infra*, pp. 60–61), and Sections 29.41–1 and 29.41–2 of Treasury Regulations promulgated thereunder (Appendix, *infra*, pp. 64–65), authorize taxpayers (with exceptions not relevant here) to choose the accounting method by which they are to keep their books and compute their income for tax purposes. The effect on gross income of choosing the accrual method, selected by taxpayers in the cases at bar, was

explained by this Court in *Spring City Co.* v. *Commissioner*, 292 U.S. 182, 184, as follows:

> Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues.

Under settled principles of tax law, therefore, it is the right to receive and not the actual receipt of an item of income which determines its includibility in gross income under the accrual method of accounting. *Brown* v. *Helvering*, 291 U.S. 193; *Spring City Co.* v. *Commissioner, supra.* As explained more fully below, taxpayers in the instant cases acquired a fixed right to receive the amounts credited to them, as well as the rest of the gain from sales of their property, in the year in which the sales and credits were made. Accordingly, inclusion of those amounts in such year was in accordance with the accrual method of accounting for tax purposes.[15]

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[15] That the accounting practice adopted by taxpayers in the instant cases differed from this view—even if it is assumed, *arguendo*, that the practice was correct from a theoretical or business accounting viewpoint—is, of course, not controlling here. "The income tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer." *Weiss* v. *Wiener*, 279 U.S. 333, 335. See also, *Lucas* v. *American Code Co.*, 280 U.S. 445, 449; *Brown* v. *Helvering*, 291 U.S. 193, 203. "* * * the form of a transaction as reflected by correct corporate accounting opens questions to the proper application of a taxing statute; it does not close them." *Bazley* v. *Commissioner*, 331 U.S. 737, 741.

Taxpayers' right to receive the face amount of the retail paper executed in their favor was not rendered non-accruable merely because the paper might not prove collectible when due. *Spring City Co.* v. *Commissioner, supra; Automobile Ins. Co.* v. *Commissioner,* 72 F. 2d 265 (C.A. 2d); *K. Taylor Distilling Co.* v. *Commissioner,* 42 B.T.A. 7. That possibility constitutes a normal business risk which does not justify postponement of accrual. *Elmer* v. *Commissioner,* 65 F. 2d 568 (C.A. 2d); *Alworth-Washburn Co.* v. *Helvering,* 67 F. 2d 694 (C.A.D.C.).

Nor was the taxpayers' right to receive payment from the amounts credited to the dealers' reserve accounts rendered non-accruable by the provisions of the agreements between them and the respective finance companies. Taxpayers would ultimately receive payment of the credits either in cash or in the offset of their obligations to the finance companies. Accordingly, they realized income when the credits were made. The alleged "contingencies" with respect to the payments from the dealers' reserve accounts were not sufficiently substantial, either from the standpoint of the legal liability of the finance companies to pay over or from the standpoint of collectibility, to prevent accrual of income. The contrary arguments of taxpayers, as expressed below, fail to distinguish between the concepts of payment and vesting. As the Court of Appeals observed in the *Baird* case (B.R. 86):

> Taxpayers confuse the arrangement with respect to *payment* of the sums in the reserve accounts with the vesting * * * in the relevant years of a fixed right to receive in due course

> definite sums which had become accruable * * * at the times of sale * * *. There is no uncertainty with respect to the amounts accrued * * *. These amounts were definitely fixed at the time the funds were placed to * * * [taxpayer's] credit in the * * * reserve accounts. Moreover, there is no showing that the amounts in the reserve accounts would not be collectible at the appropriate time or that collection would be improbable * * *. In the light of the record, it cannot logically be argued that the reserve would never be realized * * *.[16]

B. *The concept of an annual accounting*

Section 41 of the 1939 Code requires that every taxpayer, regardless of his accounting method, compute his income on the basis of an annual accounting period. Since income is by its very nature a flow, rather

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[16] Even if it is assumed, *arguendo*, that in the instant cases the exact amounts in the dealers' reserve accounts which taxpayers had a right to receive was in dispute, and that eventually they might actually receive only part, or even none, of the amounts credited; accruability is not necessarily foreclosed. Under the claim of right doctrine first enunciated by this Court in *North American Oil* v. *Burnet*, 286 U.S. 417, and reaffirmed in *United States* v. *Lewis*, 340 U.S. 590, and *Healy* v. *Commissioner*, 345 U.S. 278, taxpayers still would be obliged to report the amounts in the reserves as income, when the credits were made. The decisions make it clear that the claim of right doctrine applies to accrual, as well as cash basis, taxpayers. See *North American Oil* v. *Burnet*, *supra*, pp. 421–422, 423–424, affirming 50 F. 2d 752, 755–756 (C.A. 9th); *Brown* v. *Helvering*, *supra*, pp. 199–200; *Clay Sewer Pipe Assn.* v. *Commissioner*, 139 F. 2d 130, 132 (C.A. 3); *South Dade Farms* v. *Commissioner*, 138 F. 2d 818 (C.A. 5th). And, on principle, there would seem to be no warrant, in applying the doctrine, for distinguishing between the actual receipt of income and the fixation of the right to receive it.

than a static condition or object, the imposition of a tax upon income requires that points of time be fixed between which income is measured for tax purposes. Computation of income on such an annual basis is, as a general matter, essential both to assure the Government a regular and ascertainable production of revenue and to provide a system susceptible of practical operation. See *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 365; *Brown* v. *Helvering*, 291 U.S. 193, 199. Since income-producing transactions often extend over a period of more than one year, the annual basis of accounting requires that the computation of income for tax purposes show the net result of all of the taxpayer's transactions during the year rather than the net result of any particular transaction which may extend beyond that period. *Guaranty Trust Co.* v. *Commissioner*, 303 U.S. 493, 494, 498. As this Court observed in *Sanford & Brooks Co., supra* (pp. 363, 364–365):

> All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt. * * *
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> * * * * * * *
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> A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him

> from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

In the instant cases, notwithstanding the possibility that customers might in later years default in their payments, the amounts credited to taxpayers, like the rest of their gain from the sales made during the year, constituted income which was required to be reported on an annual, rather than a transactional, basis.

II. The administrative practice

The clear and consistent administrative practice of the Internal Revenue Service in treating amounts credited to dealers' reserves, in the conventional situations reflected in the instant cases, as the accrued income of taxpayers in whose favor the credits are made, carries substantial weight. As this Court said in *Lucas* v. *American Code Co.*, 280 U.S. 445, 449:

> * * * the direction that net income be computed according to the method of accounting regularly employed by the taxpayer is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income. Much latitude for discretion is thus given to the administrative board charged with the duty of enforcing the Act. Its interpretation of the statute and the practice adopted by it should not be interfered with unless clearly unlawful.

Again, in *Automobile Club* v. *Commissioner*, 353 U.S. 180, the Court emphasized that the Commissioner's de-

terminations in the area of accounting practices are to be given particular respect.

As early as 1931, approximately nine years before the decision in *Shoemaker-Nash, Inc.* v. *Commissioner,* 41 B.T.A. 417, the first reported case dealing with the dealers' reserve issue, the Internal Revenue Service, in G.C.M. 9571 (Appendix, *infra,* pp. 65–70), announced that credits made by finance companies to dealers' reserves constituted the accrued income of dealers for the years in which the credits were made. The Ruling observed that in the event "the purchaser fails to meet his obligation, the dealer is given the benefit of the reserve credit through a corresponding reduction in his liability to the finance company." In rejecting the contention that no accrual of income occurs when the credits are made, because the purchaser of the automobile might prove delinquent, the Service stated that (Appendix, *infra,* pp. 68–69)—

> inasmuch as the taxpayer has adopted the accrual method of accounting, he must be consistent in the treatment of all items of income. Such treatment, under the accrual method, demands that each item of income shall be accrued when earned rather than when received. This is the basis upon which the theory of "accrual" is founded, and the possibility of an item of earned income not being received due to some unforeseen circumstances is immaterial. It is true that where an entry on the books of account is based on a remote contingency which may never happen such item could not reasonably be accrued for income tax purposes. * * * The contingency must, how-

ever, be something more than the mere possibility of the debtor not satisfying his indebtedness. There is always a possibility, where the relationship of debtor and creditor exists, that the debtor may not pay, due to financial reverses, but if the possibility of such failure to pay is accepted as a reason for not accruing an item of income the whole theory of the accrual method of accounting must fall where commercial transactions are concerned.

* * * The facts show that the reserve credit is not a contingent credit but is paid to the dealer either at the time the note is liquidated by the purchaser of the car or, in case the purchaser fails to meet his obligation, the dealer is given the benefit of the reserve credit through a corresponding reduction in his liability to the finance company. It follows, therefore, that the reserve credit to the dealer is an absolute credit by the finance company and is payable to the dealer without limitation, regardless of whether the obligation is liquidated by the purchaser (who is the maker of the note) or by the dealer (who is the indorser thereof).

Revenue Ruling 57–2 (Appendix, *infra*, pp. 61–64), which reaffirmed G.C.M. 9571 and described with somewhat more particularity the steps generally involved in setting up dealers' reserve accounts,[17] de-

[17] The Ruling states in part:

"When a car is purchased on credit from a dealer, the purchaser makes a down-payment, either in the form of cash or by turning in another car at an agreed value, the balance being satisfied by the purchaser's promissory note and a supporting conditional sales contract. The face amount of the note re-

clared that when the purchaser gives the dealer a note reflecting "the balance of what would be the purchase price of the car, if bought for cash, and a finance charge", the transaction is "closed and completed" as between purchaser and the dealer, *"with the attendant tax consequences to the dealer"*. (Emphasis supplied.) The Ruling also reaffirmed the Service's consistent policy of treating the credits to the dealers' reserve accounts as accruing to the dealers

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flects two elements—the balance of what would be the purchase price of the car, if bought for cash, and a finance charge. * * *

"It is then common practice of the dealer to sell or discount the purchaser's note and sales contract to some financial institution. The finance company or bank acquires the note at a value somewhat less than its face value, the difference representing a charge for its service. Simultaneously, either cash or unrestricted credit is given to the dealer to the extent of the amount reflected in the face value of the note that corresponds to the unpaid balance of the cash retail price of the car. The difference between the face value of the note and the sum of the finance company's charge and its credit or immediate payment to the dealer (representing part of the finance charge previously mentioned) is then credited on the books of the finance company as a liability of the finance company to the dealer. The accumulation of these credits is generally known as a 'dealers reserve' * * *.

"Settlement of the liability represented by the reserve is subject to agreement between the particular dealer and the financial institution involved. In some instances, the agreement does not contemplate the charging of any items against the reserve account, while in others the account reflects a running record of various transactions between the parties, that is, both credits and charges are entered, depending upon the nature of the item. Thus, in certain instances, the dealer and the finance company may agree that notes purchased or discounted are to be charged to the reserve account in the event they become worthless."

as of the time the credits are made—whether the "dealer's reserve is in the nature of a running account" between dealer and finance company (as, for example, where the two parties have agreed that "notes purchased or discounted are to be charged to the reserve account in the event they become worthless"), or whether "losses incurred by a finance company on notes purchased from automobile dealers may not be charged against the reserve * * * even though the dealer is not immediately or even currently able to draw on the entire reserve."

Thus, from 1931 to the present day—a period during the course of which there have been two complete revisions of the Internal Revenue Code—it has been the announced position and the consistent practice of the administrative authorities to treat the very types of credits involved in these cases as constituting the accrued income of those dealers in whose favor the credits stand. During this entire period, Congress has not seen fit to make any change in the law. Cf. *Cammarano* v. *United States*, No. 29, this Term, decided February 24, 1959.

III. The nature of the transactions

The sale and financing arrangements in the instant cases have been recently interpreted by the Courts of Appeals as susceptible of two differing constructions. The first (see *Baird* v. *Commissioner*, B.R. 82, 85; *Schaeffer* v. *Commissioner*, *supra*, 258 F. 2d at 865) is that the arrangements, in their totality, reflect two separate and distinct, albeit practically contemporaneous, transactions: (1) the sale of the commodity

to the purchaser at a total time price, including finance and other charges, the purchaser executing a note or other evidence of obligation in favor of the dealer; and (2) the sale of the paper to a finance company, the latter paying the dealer a certain sum in cash and crediting a certain additional amount to a so-called dealer's reserve account. The second construction (see, *e.g., Hansen* v. *Commissioner,* H.R. 89–90; *Texas Trailercoach, Inc.* v. *Commissioner,* 251 F. 2d 395, 404, (C.A. 5)) is that the total arrangements reflect a single, tripartite, transaction involving the dealer, the purchaser, and the finance company.

The first approach leads necessarily to the conclusion that taxable income accrues to the automobile dealer, just as it accrues to any other seller who makes a sale of property and extends credit to the buyer. Certainly, the fact that a seller may then proceed to borrow from a bank or lending agency by assigning or pledging his accounts receivable does not mean that those accounts have not accrued for tax purposes.

For the reasons elaborated below, we believe it correct to treat as two discrete transactions the sale to the buyer (accompanied by execution of the buyer's note in favor of the seller) and the subsequent sale of the retail paper to the finance company. It is particularly significant (though there are also other factors which support this analysis) that in none of the cases before the Court was the automobile dealer under any legal obligation whatever to discount the paper which he received from the purchasers.

We argue further that, even if one treats the arrangements involving buyer, seller and finance company as constituting a single three-cornered transaction, it is nonetheless erroneous to view the amount held by the finance company in the dealer's reserve account as a contingent liability of the finance company not yet accrued by the dealer. The essential consideration here is that the dealer, by disposing of the retail paper instead of holding it himself, has nowise added to the risks or contingencies. The risk of his not being paid in full is the same risk as if he had held the paper himself—that the buyer of the automobile may default on his obligation and that the repossessed car may prove insufficient in value to satisfy the debt. The fact remains that the dealer has accrued his gain upon the completion of the sale. The risk is no more than the normal risk of any commercial seller who has sold on credit rather than for cash.

Thus, we submit, either approach should lead to the same tax result.

A. *The two-transaction hypothesis*

In each of the instant cases, taxpayers—not the finance companies—sold the commodities involved. Each sale was evidenced by an agreement between dealer and purchaser whereby the purchaser was obligated to pay a total time price. The time price included, among other things, the finance charge. The major portion of that charge was to be ultimately received by the finance company; a portion of it,

however, was allocated to the dealer.[18] Insofar as the purchaser was concerned, the total time price (including finance and other charges) which was evidenced by the face amount of the paper made payable to the dealer represented the price of the commodity—just as the cash amount paid would have been so regarded if the purchaser had bought the commodity outright; just as the amount paid on a time basis would have been so considered if the dealer himself had chosen to retain the retail paper. Nor can there be any real doubt that *taxpayer-dealers* regarded the

[18] In *Hansen*, the amended petition filed by taxpayer in the Tax Court admitted (H.R. 10) that "The contract between petitioners and G.M.A.C. required that a contingent liability reserve, called 'Dealer's Reserve,' be withheld by GMAC out of the finance charges." The Commissioner's explanation of adjustments for the taxable years recognized that the finance charge was included in the gross sale price of each automobile, and that the finance charges had been withheld by G.M.A.C. under its retail financing plan, in "a contingent reserve for possible losses." (H.R. 18, 21.) Taxpayer testified that (H.R. 30): "we figured the cash price on the car, deducted * * * [the] down payment and then computed what the finance cost would be on the unpaid balance and what the monthly payments would be * * *." The premise of taxpayer's argument in the Tax Court was that the amounts withheld by G.M.A.C. and credited to the "Dealer's Reserve" represented finance fees. (H.R. 43, 45.) The Tax Court found that the "Total Time Price" for each automobile sold included "the cost of any insurance and finance charges"; that under the reserve account maintained between taxpayer and G.M.A.C. "at least 5 per cent of the outstanding balances of the contracts assigned to GMAC were retained by it"; and that "in the event of prepayment by a customer, the proportionate reduction in finance charges was charged to the reserve." (H.R. 61, 63–64.) In the Statement of Points before the Court of Appeals taxpayer adverted to the "finance fees withheld in contingent liability reserve by General Motors Acceptance Corporation." (H.R. 76.)

total time payment—including, certainly, that portion of the finance charges allocable to them—as the *quid*

The record in *Glover* makes no specific reference to the composition of either the time charge to taxpayer's purchasers, or of the credits to the dealer's reserve account. The agreement with the Universal C.I.T. Credit Corporation provided that the finance company's "rate charts will include, for * * * [the] protection * * * [of taxpayer] reserves as outlined in * * * [the] reserve arrangement effective at the time paper is purchased by" the finance company. (G.R. 28.) The Court of Appeals simply concluded that taxpayer received "notes of purchasers representing the balance due on the purchase price"; that the notes were sold to the finance company "pursuant to a written contract prepared by the finance company"; that "On transfer and delivery of the notes the taxpayer received 97% of the face value of the notes and the finance company withheld 3% and this transaction was evidenced on the books of the finance company by an entry of this 3% * * * in an account called the dealer's reserve account." (G.R. 36–37.)

In the *Baird* case it was stipulated that in connection with the sale of trailers under conditional sales contracts "the purchaser executed a note payable to the partnership for the unpaid purchase price of the trailer, plus insurance, interest and financing charges" (B.R. 15); that "Under the terms of its agreements with the three finance companies, the partnership sold most of its trailer notes to the finance companies for the deferred purchase price of the trailers plus in certain cases a percentage of the interest or finance charges"; that "The amount withheld and credited to * * * [the reserve account] was usually 5 percent of the unpaid balance on each note * * * [in some instances, only 3 percent, and that] in certain instances, Minnehoma and Midland also credited to the partnership's account a portion of the finance charge" (B.R. 16; Ex. 12-L, B.R. 31–32; Ex. 13-M, B.R. 36–37). See also Exhibit 18-R (B.R. 40–42), in which one of the finance companies (Midland) announced that it was setting up "a dealer profit reserve equal to 1% of the unpaid cash balance of each retail contract * * * derived from the service charge and * * * [to] be paid to the dealer when the retail contract is paid out."

pro quo for their sale of the commodities. The Court of Appeals in the *Hansen* case recognized as much, in subscribing to the Fifth Circuit's view, expressed in *Texas Trailercoach, Inc.*, v. *Commissioner, supra*, 251 F.2d at 397, that "When we get down to what actually happens * * * the finance company * * * has a *fixed percentage for its finance charges worked into the sales price.*" (H.R. 90.) (Emphasis supplied.) The correctness of that view is indicated by even a cursory examination of the origin, development, and function of the practice of dealer participation in finance charges. See Hardy, *Another View On The Origin of Dealer Participation In Automobile Finance Charges*, 30 Ind. L.J. 311 (1955).[19]

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[19] According to the author, the practice of adding to the finance charge a part to be collected from the purchaser and paid to the dealer was originated by General Motors Acceptance Corporation (GMAC) some time in 1925. Prior thereto, notes taken by dealers in retail transactions were simple promissory notes, in a principal amount equal to the balance due by the purchaser, bearing a percentage rate of interest. Generally, the dealers retained the notes or transferred them variously to GMAC, other finance companies, or banks, according to their own interests. The principal advantage of the transfers by dealers was the conversion of their notes to cash, in effect making the sales of cars cash transactions. The dealers did not expect profit on the sale of the notes, and it was virtually non-existent. By 1925 it became clear to GMAC that it was losing much of its business to independent finance companies and others. In order to meet that exigency (as well as to assure, to the greatest extent possible, its control of the business of financing the sales of General Motors cars) GMAC decided, in the latter part of 1925, to inaugurate, among other things, a dealer profit participation in the finance charge. By the end of 1926—GMAC's volume of business and net earnings having increased by approximately 225 percent over the previous year—the dealer participating practice was perma-

In none of the instant cases was the taxpayer-dealer legally obligated to sell any of its retail paper to the particular finance company or companies with which it did business, or, indeed, to any company at all.

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nently fastened to a large part of the automobile business (General Motors' proportion of the business was about 40 percent at that time). Knowledge of GMAC's success spread at once throughout the automobile business, with the result that other motor companies (Chrysler through Commercial Credit, and Ford through Universal Credit) followed suit. And since Ford and Chrysler then represented about fifty percent of the automobile business, independent finance companies were again confronted with the choice of abandoning a large part of their business or of matching the Ford and Chrysler dealer participation.

See also, Note, *Is Control Of Dealer Participation A Necessary Adjunct To Regulation Of Installment Sales Financing?*, 28 Ind. L.J. 641 (1953); and Pecar, *Dealer Participation In Automobile Finance Charges: A Reply*, 30 Ind. L.J. 319 (1955). While both of these latter articles are addressed primarily (as is the Hardy article, *supra*) to other problems in the field of automobile financing, they, too, make the basic assumption that the amounts credited to the dealers' reserve accounts in the arrangements between dealers and finance companies represent, in intention and reality, part of the purchase price for the commodities sold, ultimately to be paid to the dealers. Thus, the Pecar article, *supra*, p. 321, speaks of the "inclusion of financing costs in the sales price of the automobile." And the Note, *supra*, pp. 644, 649, 658, describes the dealer participation arrangement as the "obvious increment to the finance charge"; as the "first and foremost" method employed by finance companies "to obtain dealer business"; as "the pièce de résistance" among the "methods of enticing dealers", in the case of the smaller finance companies; and as so clearly a means of providing an additional *quid pro quo* to the dealer on the sale of the commodity as to warrant the observation that "Today when a dealer makes arrangements to finance his paper, his first question is, 'How much do I get and when do I get it?'"

Thus, in *Baird,* the court below found that taxpayer (B.R. 85) "had complete freedom of choice in this regard and conversely each finance company was free to take or refuse the offered paper." In *Glover,* it was stipulated that the finance company only *proposed* to buy from taxpayer the paper acceptable to it, and that it could "stop buying" taxpayer's paper, presumably at will. (G.R. 24, 25.) Conversely, nothing in the *Glover* record indicates that taxpayer was legally obligated to sell any paper to the finance company. In *Hansen,* the Tax Court found that (H.R. 63) "There was no specific contract with GMAC requiring petitioner to assign any of his contracts to GMAC * * * or to any other finance company"; on the contrary, taxpayer "could hold such contracts himself without assignment."

In these circumstances, the dealer-purchaser transaction in each of the instant cases was indeed "completed * * * at the time the down payment was made, either in cash or trade-in allowance, or both, and the purchaser executed and delivered to it notes" or other paper, at which time the dealer had a "complete enforcible right to receive the remainder of the purchase price at the times specified in the retail paper." *Baird* v. *Commissioner.* (B.R. 82.) In fact, in *Schaeffer* v. *Commissioner, supra,* 258 F. 2d at 865, the Court of Appeals considered the "prior" dealer-purchaser transaction to be *"the controlling factor in the case,"* the dealer acquiring thereby "an asset in the nature of an account receivable, with respect to which there was no contingency whatsoever," with the resultant accrual of "the entire amount of the contract obliga-

tion." (Emphasis supplied.) Even the *Hansen* opinion appears to acknowledge that "such an approach is entirely consistent with the principles of accrual accounting" and that "[i]t *can* be reasoned that the right to the sale price is fixed at the time of the contract, thereby requiring the dealer to accrue that amount, although he has actual receipt of only 95% thereof * * *." [20] (H.R. 89.) (Emphasis supplied.)

It is, of course, fundamental that an accrual basis taxpayer receiving payment in the form of a promis-

[20] The *Hansen* opinion erroneously suggests that the only amount not includable in the year of sale would be "that portion of the finance charges to which the dealer is entitled as they become fixed". (H.R. 89.) But under the two-transaction hypothesis the finance charge is part of the purchase price agreed to be paid for the commodity, as evidenced by the note issued to the dealer in the amount of the full time price. The *full* purchase price is accruable, regardless of the fact that part of it derives from the charge of servicing the transaction. And even if the two-transaction hypothesis is ignored, and the transaction is considered as a single, tripartite, arrangement involving dealer, purchaser, and finance company, the fact is, nevertheless, that the dealer sells the retail paper, a chose in action, to the finance company for a total consideration (including the component attributable to the service charge) payable partly in cash, and partly on a deferred basis, out of amounts credited to the dealer's favor in the reserve account. The *full* amount to be paid for the paper (including the credits which will ultimately be satisfied by cash payment, or by discharge of the dealer's obligations to the finance company) accrues upon sale of the paper and entry of the credits. Nor can any of the credits in the dealers' reserve accounts in the instant cases be regarded as the payment of interest to the taxpayer-dealers. Interest "is the amount which one has contracted to pay for the use of borrowed money". *Deputy* v. *DuPont*, 308 U.S. 488, 497. No money was borrowed by purchasers from the taxpayer-dealers: the finance companies financed the transactions.

sory note (or any other chose in action) which appears to be collectible cannot refuse to accrue the amount of the obligation merely because it might not prove collectible when due. Indeed, if mere uncertainty of payment, inherent in every debtor-creditor relationship, is to be considered sufficient reason for not accruing an obligation, then the whole theory of accrual accounting in regard to commercial transactions is undermined. See Whittaker, *Accruability of Dealer Reserves Withheld by Finance Company*, 55 Mich. L. Rev. 733, 734 (1957); *Spring City Co.* v. *Commissioner, supra; Automobile Ins. Co.* v. *Commissioner, supra; K. Taylor Distilling Co.* v. *Commissioner, supra; Elmer* v. *Commissioner, supra; Alworth-Washburn Co.* v. *Helvering, supra.* Even if it is assumed that taxpayers in the instant cases fall within the category "of those who, without sufficient capital, enter into a competitive business field, where [assertedly] risks are high and many", the irrelevancy of that fact was correctly noted by the Court of Appeals in the *Baird* case (B.R. 81):

> * * * such an entry is voluntary and we know of no power which courts have to grant relief from the burden of income tax laws to persons who thus find themselves "at the mercy of the finance companies". Congress has power to lay and collect income taxes. If the application of the income tax laws to persons situated as taxpayers say they were, requires special consideration, it is for Congress to say so, not us. Our duty is to ascertain what the law is and apply it * * *".

In any event, however, the records in the instant cases do not support any suggestion of special risk. In the *Baird* case, no delinquencies were charged to the dealer's reserve accounts by any finance company during the taxable years; the total deductions of the partnership for bad debts, only a part of which reflected advances by the partnership to meet purchasers' defaults in payments, amounted to only $1,203.75 for 1952, $2,239.12 for 1953, and $1,203.69 for 1954. (B.R. 78.) The gross sales for each of those years were well over one million dollars. (B.R. 44). In the *Hansen* case, taxpayer charged off bad debts specifically as they became worthless. (H.R. 64.) However, taxpayer testified that the bad debts charged off "had nothing to do * * * with the credit sales of automobiles". (H.R. 32.) His accountant testified that the bad debts appearing on the book of accounts and tax returns "have nothing to do with the financing of automobiles" but were "entirely the result of sales on open account or parts, accessories, repairs, or other bits which incurred incidental to his business." (H.R. 37.) In the *Glover* case, taxpayer deducted the following amounts as bad debt expenses: 1949—$1,897.74; 1950—$7,393.20; 1951—$4,167.05. (G.R. 31.) His gross retail sales for those years from new and used passenger cars, as shown in the copies of the returns which are before this Court (Respondent's Exhibits B, C, D; G.R. 19) were well over three million dollars.

Nor should the fact that the dealer, in lieu of retaining the paper, sold it by "subsequent act" to a finance company "in a transaction which left a part

of the sales price of the paper temporarily retained as security by the finance company" forestall the full accrual of the account receivable resulting from the dealer-purchaser transactions. (*Baird* v. *Commissioner*, B.R. 82.) "The income * * * accrued * * * before the transfer * * * to the [f]inance [c]ompany, and such subsequent transfer does not change the legal effect of the prior completed transaction." *Schaeffer* v. *Commissioner*, *supra*, p. 865; see also, *Chamberlin* v. *Commissioner*, 207 F. 2d 462 (C.A. 6), certiorari denied, 347 U.S. 918.

In this connection, it is immaterial that the sale and financing arrangements in the instant cases may have contemplated, *ab initio*, that the time balances owing by the purchasers would be paid directly to the finance companies. Contrary to the one-transaction hypothesis accepted below in *Hansen* and, presumably, in *Glover*, we submit that the rationale of this Court's decision in *Raybestos-Manhattan Co.* v. *United States*, 296 U.S. 60, requires one to view the dealer-purchaser-finance company arrangements as involving two separate sets of transactions and legal relationships.

In *Raybestos-Manhattan*, corporations A and B, pursuant to a consolidation agreement, conveyed their property to corporation C, in return for shares of C's capital stock. The stock was not issued to A and B but to their stockholders. The taxpayer (corporation C) and the Government were "not in accord as to the precise interpretation to be placed upon the contracts which resulted in the consolidation"; but this Court, "for purposes of decision * * * assume[d] that it was agreed by all concerned that the shares

* * * were to be issued directly to the stockholders of * * * [A and B] without further intervention by the latter". On that hypothesis, it was urged that there was no transfer of shares to A and B within the meaning of the stock transfer tax provisions.

This Court, however, held that the consolidation agreement contemplated (1) the right of A and B to receive the stock in question by virtue of the transfer of their property to C ("the generating source of the right to receive"); and (2) their effective disposition of that right, through the arrangement with C, to have the shares issued directly to their stockholders. In the Court's view, the situation in *Raybestos-Manhattan* was the same *"as if the several legal relationships of the parties had been established at different times and by separate documents"*. This Court did not discern *"even a technical difference of any significance"* between (1) a hypothetical situation in which A and B convey property to C in exchange for C's shares of stock, to be issued as A or B direct, where it is later ordered that the certificates be issued to the stockholders of A and B, and (2) the situation in the case before it, "where the same duty to issue the stock is created and the same shift of the beneficiaries of it is effected *simultaneously in a single document*". (Emphasis supplied.)

By the same reasoning, we submit, in the instant cases the sale of the commodities and execution of retail paper (involving dealer and purchaser) and the transfer of the paper and the entry of credits in the dealers' reserve accounts (involving dealer and finance company) must be regarded for tax purposes

as reflecting "several legal relationships of the parties * * * established at different times and by separate documents" (*Raybestos-Manhattan Co. v. United States*, *supra*, p. 63). There were separate "legal transactions, no one of which is fictitious or so lacking in substance as to be anything different from what it purports to be", each possessing the "reality and genuineness" which require their independent recognition for tax purposes. *Chamberlin* v. *Commissioner*, *supra*, pp. 468–469, 471. Cf. *Gregory* v. *Helvering*, 293 U.S. 465; *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609; *Higgins* v. *Smith*, 308 U.S. 473; *Commissioner* v. *Court Holding Co.*, 324 U.S. 331; *Bazley* v. *Commissioner*, 331 U.S. 737; *Tennessee, Alabama & G. Ry. Co.* v. *Commissioner*, 187 F. 2d 826 (C.A. 6th).

B. *The single-transaction hypothesis*

Even if it is assumed, *arguendo*, that each sale of commodity, execution of retail paper, transfer of the paper, and entry of credits to a dealer's reserve account constituted a "single three-cornered arrangement involving the dealer, the purchaser, and the finance company" [21] (H.R. 89), the tax result here is,

[21] Paragraph 1 of the agreement between taxpayer in the *Glover* case and the Universal C.I.T. Credit Corporation provided for the sale of paper with recourse only as to the transactions covering certain types of "commercial cars." Paragraph 7, however, provided that if the dealer should "*disclose* any part of this agreement to the customer," the dealer would then be "under full recourse liability * * * on the assignment of paper," regardless of the type of commodity involved. (G.R. 27, 29.) (Emphasis supplied.) This type of provision hardly supports the conclusion that the parties contemplated a single, tripartite arrangement. Such a conclusion

nevertheless, the same. The amounts credited to the dealers' reserve accounts—which, together with the cash payments immediately made by the finance companies to taxpayers, embodied taxpayers' gain—accrued to taxpayers in the year in which the credits were made. In those years, taxpayers' "legal right to * * * [the credits] was undisputed, and * * * only the time of payment was deferred." *Schaeffer* v. *Commissioner, supra* 258 F. 2d at 864. Since taxpayers were on the accrual basis, the inclusion of the credits in income was governed by "the right to receive and not the actual receipt." *Spring City Co.* v. *Commissioner, supra,* 292 U.S. at 184–185; *North American Oil* v. *Burnet, supra,* 286 U.S. at 423.[22]

The contrary conclusion reached by the courts below in the *Hansen* and *Glover* cases rests, in essence, upon the erroneous premise (rephrased and controverted in *Schaeffer* v. *Commissioner, supra,* 258 F. 2d at 864) that the credits were payable "only upon various conditions precedent, which were contingencies which might bar indefinitely the dealer's receipt of the payments or the right to receive any payments at all from the account, thus constituting them contingent credits, rather than accrued income." There is no clear-cut test by which to determine whether a

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would be anomalous, indeed, where it was contemplated that two of the parties (dealer and finance company) would keep the terms of their agreement beyond the knowledge of the third party (the purchaser).

[22] See fn. 16, *supra*, as to the application of the claim of right doctrine to taxpayers' fixed right to receive the amounts reflected in the dealers' reserve accounts (either in cash, or in the discharge of their obligations to the finance companies).

right to receive is sufficiently contingent to prevent accrual. See Holland, *Accrual Problems in Tax Accounting*, 48 Mich. L. Rev. 149 (1949). What is a substantial contingency is basically a question of degree. 2 Mertens, *Federal Income Taxation* (Rev.), Sections 12.61 and 12.62. This much, however, is clear. The possibility that a purchaser, solvent at the time of sale, will default is not the type of substantial contingency which will justify deferring the accrual of income. The opinions in *Hansen* and *Glover* have "failed to show in what respect the dealer reserve arrangement involves any greater contingency" than purchaser default. See, Note, *Taxation-Deferred Income-Amounts Credited To "Dealer Reserve" Account Are Income To Accrual Basis Taxpayer When Credited*, 42 Minn. L. Rev. 151, 154 (1957).

The "contingencies" in the instant cases arose in one, or a combination, of the following contexts: (a) where the credits were pledged to cover the finance company's losses arising out of defaults in, or acceleration of, the payments by purchasers; (b) where the credits were pledged to cover the liabilities of the dealer to the finance company, arising out of the guaranty in connection with the sale of the retail paper, or out of other contractual arrangements; and (c) where, without provision for any corresponding depletion of the dealer's reserve account, the dealer incurred a matured obligation of any nature to the finance company. Thus, in the *Glover* case, taxpayer apparently sold most of the retail paper without

recourse.[23] There was no agreement for charging individual worthless notes to the dealer's reserve. While it is true that the Court of Appeals considered that there were (R. 40) "at least four specific unperformed obligations of taxpayer, the nonperformance of any one of which would have changed the amount of the reserve withheld to which * * * [taxpayer] might claim a right in the future," fulfillment of these obligations took place only upon the occurrence of a condition subsequent, and none involved the contemporaneous depletion of the credits to the dealer's reserve account. On the contrary, the finance company was required, "[t]hree times in each twelve-month period" to pay over to taxpayer the "accumulated reserves in excess of 3% of the * * * aggregate unpaid balances" on all paper which it had purchased from taxpayer; prolonged retention of the entire reserves would occur *only* when the finance company stopped buying taxpayer's retail paper, at which time, it was agreed, the finance company could "hold and apply all reserves until liquidation of all paper purchased from [taxpayer] is completed." (G.R. 28.) It is apparent, moreover, that in any event taxpayer ultimately would receive the full amount credited to the dealer's reserve account in cash or in the discharge of his obligations to the finance company.[24]

[23] The agreement with the Universal C.I.T. Credit Corporation provided for the purchase of all retail paper "without recourse as to the customer's obligation of payment," except as to paper covering certain types of "commercial cars," and "cars sold to relatives or employees." (G.R. 23.)

[24] If so applied, the taxpayer would, of course, realize income the same as if he had actually received the amounts credited.

In the *Hansen* case, the endorsement executed by taxpayer upon the assignment of each contract to G.M.A.C. included a guaranty to pay to the finance company "the full amount remaining unpaid" by the purchaser, and a covenant that "if default be made in payment of any instalment" by the purchaser taxpayer would "pay the full amount then unpaid to General Motors Acceptance Corporation upon demand." (Joint Ex. 5–E; H.R. 39–40.) The Tax Court found that the purpose of the dealer's reserve account was "to protect GMAC against any loss arising from the repossession of any automobile in case of default in payment," and also, "in the event of prepayment by a customer," against the "proportionate reduction in finance charges." (H.R. 63–64.)[25] Here, too, there was no provision for current depletion of the reserve account, except possibly in the case of finance charge refunds attributable to prepayments. In any event, as in the *Glover* case, taxpayer

Old Colony Trust Co. v. *Commissioner*, 279 U.S. 716, 729; *Tressler* v. *Commissioner*, 228 F. 2d 356, 359 (C.A. 9th). The charging of the reserves in the instant cases involved, in substance, cancellation of taxpayers' obligations, giving rise to a form of income. *United States* v. *Kirby Lumber Co.*, 284 U.S. 1; *Clarke* v. *United States*, 94 F. Supp. 543 (E.D. Pa.), affirmed, 189 F. 2d 101 (C.A. 3d); 2 Mertens, *Federal Income Taxation*, Sec. 11.19 (1955).

[25] Taxpayer testified that the dealer's reserve account maintained by G.M.A.C. "was a reserve set up *in case that I folded up* it would protect the finance company to repossess; the cars would be worth less than what the contract calls for to pay back G.M.A.C. Also, in case of any prepayment on contracts, there would be a reserve there, then refund the customer part of the financing cost, which would be chargeable in direct proportion from what I received on the financing costs." (H.R. 31.) (Emphasis supplied.)

would ultimately receive in cash the amounts credited to the dealer's reserve account, or would realize income upon the application of those credits to the discharge of his obligations to the finance company, arising out of the aforementioned guaranty and covenant.

In the *Baird* case, the partnership either endorsed the retail paper sold to the finance company, with recourse, or guaranteed payment. In addition, the agreements with the finance companies provided, in effect, that each finance company could look to the balance in the dealer's reserve account to cover any default by purchasers, any repossession losses, or any default by the partnership with respect to its guarantees or other matured financial obligations, of any nature, to the finance companies. While it was possible, as the Court of Appeals observed, that the partnership "would not receive all of the amounts in cash, the parts withheld would in all events be used for the benefit of the partnership to satisfy its future obligations, if any, to the finance companies." (B.R. 86.) Here, too, then, "Ultimately only two things could happen to the funds in the dealer's reserve accounts: either the amounts would be paid * * * in cash or they would be used to satisfy * * * [taxpayer's] other obligations to the finance companies."[28] (B.R. 82.)

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[28] That at least one of the finance companies so understood the effect of the arrangements with taxpayer is indicated in the testimony of Midland's vice president. Asked for the reason that the dealer reserve account was "set * * * up * * * to protect the finance company against possible loss," he stated (B.R. 27):

"Well, we buy this paper from all of our dealers on a

This feature, common to the three cases, distinguishes them from other situations in which taxpayers might receive no income in any form. See, for example, the so-called cooperatives' reserve cases (*Long Poultry Farms* v. *Commissioner*, 249 F. 2d 726 (C.A. 4th); *Commissioner* v. *Carpenter*, 219 F. 2d 635 (C.A. 5th)), in which the taxpayer-patrons held patronage certificates representing shares in the cooperatives' net profits. These shares were subject to diminution in case the cooperatives sustained losses; were subordinate to the right of the cooperatives' creditors and all preexisting unpaid patronage certificates; and would not be paid unless and until the cooperatives' directors so resolved. These contingencies could operate to diminish the amount of cash ultimately to be received by the taxpayer-patrons without offset by any other increment in their wealth, such as a discharge of any indebtedness from the patrons to the cooperatives. See Conner, *Taxation: Federal Income Tax: Dealers' Reserves: Time When Accruable as Income: Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395 (5th Cir. 1958), 43 Corn. L.Q. 719, 722 (Vol. 4, 1958). It is true, in the instant cases, that cash payment of the credits held in reserve were to be made only when the total credits exceeded a certain percentage of the unpaid balances on all contracts or retail paper. It by no means follows that the credits did not accrue. Cf. *Keasbey & Mattison Co.*

---

straight endorsed basis, in other words, it's fully recoursed. If a trailer is given to a note-maker and the note-maker can't pay for it, the dealer has to take it back, if he can't pay us off, then, the net pay-off on the trailer, we would take the reserve money to liquidate the account."

v. *Commissioner*, 141 F. 2d 163, 167, 168 (C.A. 3d), in which the court observed that such provisions would appear to affect "merely * * * the time of", not the right to, payment, in which event the reserve should be reportable at the time of sale, since under a universally recognized principle, it is the right to receive, not actual receipt, which controls the accruability of income.

Taxpayers' real grievance in the instant cases would seem to be (H.R. 87–88) "that a tax must be paid without the funds upon which the tax is levied being available for payment of the tax." But, as the Court of Appeals correctly pointed out in the *Hansen* case (*ibid.*), "This may often be the result of accrual accounting just as it may be the result of operation of the doctrines of realization and constructive receipt." Under "basic concepts," an accrual basis taxpayer "must record income, and pay tax thereon, upon *fixation* of the right to receive income." The time of payment cannot control.

CONCLUSION

The judgments of the courts below in Nos. 380 and 381 cases should be reversed. The judgment of the Court of Appeals in No. 512 should be affirmed.

Respectfully submitted.

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MARCH 1959.

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the

net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [as amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 42.)

Rev. Rul. 57–2, 1957–1 Cum. Bull. 17:

Amounts withheld by banks or finance companies to cover possible losses on notes purchased from dealers constitute income to dealers employing the accrual method of accounting, to the extent of their interest therein at the time the amounts are recorded on the books of the bank or finance company as a liability to the dealer, regardless of whether charges for worthless notes are also made to the account pursuant to an agreement between the parties. Losses sustained on worthless notes shall be separately established by the dealer as required by section 166 of the Internal Revenue Code of 1954.

The Internal Revenue Service has been requested to state its position with respect to the treatment, for Federal income tax purposes, of amounts withheld by banks and finance companies to cover possible losses on notes purchased from automobile or other dealers employing the accrual method of accounting, and which are recorded on the books of the bank

or finance company as a liability of the bank or finance company to the dealer.

The steps generally involved in transactions concerning automobile dealers are as follows: When a car is purchased on credit from a dealer, the purchaser makes a down-payment, either in the form of cash or by turning in another car at an agreed value, the balance being satisfied by the purchaser's promissory note and a supporting conditional sales contract. The face amount of the note reflects two elements—the balance of what would be the purchase price of the car, if bought for cash, and a finance charge. As between the purchaser and the dealer, the transaction is closed and completed at this point with the attendant tax consequences to the dealer.

It is then common practice for the dealer to sell or discount the purchaser's note and sales contract to some financial institution. The finance company or bank acquires the note at a value somewhat less than its face value, the difference representing a charge for its service. Simultaneously, either cash or unrestricted credit is given to the dealer to the extent of the amount reflected in the face value of the note that corresponds to the unpaid balance of the cash retail price of the car. The difference between the face value of the note and the sum of the finance company's charge and its credit or immediate payment to the dealer (representing part of the finance charge previously mentioned) is then credited on the books of the finance company as a liability of the finance company to the dealer. The accumulation of these credits is generally known as a "dealers reserve" and is the specific object to the present consideration.

Settlement of the liability represented by the reserve is subject to agreement between the particular dealer and the financial institution involved. In some instances, the agreement

does not contemplate the charging of any items against the reserve account, while in others the account reflects a running record of various transactions between the parties, that is, both credits and charges are entered, depending upon the nature of the item. Thus, in certain instances, the dealer and the finance company may agree that notes purchased or discounted are to be charged to the reserve account in the event they become worthless.

With regard to those instances where losses incurred by a finance company on notes purchased from automobile dealers may not be charged against the reserve, the credits to the reserve, by the finance company in favor of a dealer who employs the accrual method of accounting constitute income to the dealer at the time such credit is made, even though the dealer is not immediately or even currently able to draw on the entire reserve. See G.C.M. 9571, C.B.X.–2, 153 (1931), and *Shoemaker-Nash, Inc.* v. *Commissioner,* 41 B.T.A. 417. The principles involved in the purchase of notes from automobile dealers by banks or finance companies as described above are equally applicable where notes are purchased, under similar conditions, from dealers in items other than automobiles.

Where a dealer's reserve is in the nature of a running account, the charging thereto of worthless notes pursuant to agreement between the parties has no bearing upon the fact that taxable income has been received by the dealer, or upon the time of its realization as otherwise evidenced by the credits to such reserve.

Accordingly, it is held that credits to such reserve, in the case of a dealer employing the accrual method of accounting, constitute income to the dealer at the time such credits are made regardless of whether charges to the account for worthless notes are also made pursuant to an agreement between the parties.

Losses sustained on worthless notes are to be separately established by the dealer as required by the provisions of section 166 of the Internal Revenue Code of 1954 relating to bad debts.

In arriving at these conclusions, consideration has been given the case of *Blaine Johnson et al.* v. *United States,* 233 Fed. (2d) 952. See also, *Albert M. Brodsky et ux.* v. *Commissioner,* 27 T.C. No. 23.

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.41–1. *Computation of Net Income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 29.42–1 to 29.42–3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

SEC. 29.41–2. *Bases of Computation and Changes in Accounting Methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A

method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See sections 29.42–2 and 29.42–3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see section 29.22(c)–5.)

* * * * *

Treasury Regulations 118, Sections 39.41–1, 339.41–2, promulgated under the Internal Revenue Code of 1939, applicable to the years 1952, 1953, and 1954 contain provisions similar to the above-quoted sections of Treasury Regulations 111.

G.C.M. 9571, X–2 Cum. Bull. 153 (1931):

> The taxpayer is engaged in the business of retail dealer in automobiles and finances through a finance company the time payments on sales of the cars. No formal contract between the finance company and each dealer is entered into, but in a printed booklet there are stated the principal features of the plan, one of which is a reserve maintained by the

finance company to the credit of the dealer for payment to the dealer as an account is liquidated.

When a dealer sells a car on the installment plan the purchaser executes a note for the unpaid purchase price plus a specified service charge, payable to the dealer and bearing interest at the rate of —— per cent. The note is indorsed by the purchaser and afterwards by the dealer.

The contract is then assigned by the dealer to the finance company, which remits to the dealer the amount of the face of the purchaser's note, less the service charge that has been included therein. This service charge includes the reserve which is credited by the finance company to the dealer's account. Thus the dealer, in addition to his regular profit from the sale of the automobile, receives as a reserve credit a portion of the service charge. Attached to the check remitted by the finance company to the dealer is a stub reading as follows: "Dealer, your reserve credit on this contract No. ——— is $ ———." The name and address of the purchaser are also shown on the stub. The reserve is held to the credit of the dealer and is paid to it when the account is liquidated.

The taxpayer, upon receipt of the check from the finance company in settlement of the contract, enters the amount of the reserve credit on its books by debiting "reserve fund finance company" and crediting "reserve for contingent asset of finance company." This same method is used by most dealers, though the accounts debited and credited are sometimes captioned differently. The taxpayer contends that the amount of reserve credit has not been earned because it is not known in advance whether the purchaser will completely liquidate the liability to the finance company, which is necessary before the finance company will pay the dealer.

It appears, however, that if the purchaser fails to pay, the dealer immediately becomes liable on his indorsement and is required to pay the balance due, less his reserve on the particular contract, which stands to his credit on the books of the finance company. This is in accordance with that company's method of making payment, though not specifically mentioned in the plan.

The taxpayer's books of account are kept on the accrual basis and in such cases it has been the practice of the internal revenue agent in charge to treat the reserve as an accrued item of income at the time the credit is made in favor of the dealer. The question is now presented whether this method is correct or whether the reserve credit should be treated as accrued income at the time the notes are finally liquidated, upon the theory that the income in question is contingent upon the purchaser satisfying the outstanding notes. Under the provisions of section 41 of the Revenue Act of 1928, the general rule is that net income shall be computed upon the basis of the taxpayer's annual accounting period "in accordance with the method of accounting regularly employed in keeping the books of such taxpayer." Under the provisions of section 42 of the Revenue Act of 1928, the amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer "unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period."

The accrual system of accounting is one of the "methods of accounting permitted under section 41," and recognized by the Bureau. (See articles 88, 322, and 341 of Regulations 74.) Under the accrual system of accounting receipts and disbursements are deemed received and disbursed when the income is accrued and

the liabilities are incurred. (See *American Can Co.* v. *Bowers,* 35 Fed. (2d), 832.) In *Rouss* v. *Bowers* (30 Fed. (2d), 628) the Circuit Court of Appeals for the Second Circuit said:

"When a trader keeps books on an accrual basis, the price of a sale of goods is treated as received when the account receivable is acquired, though not yet collected, and liabilities incurred are treated as outgo, though not yet paid; the receivables and liabilities are forthwith entered on the books and the bookkeeping entries are considered for tax purposes as the equivalent of actual receipts and disbursements."

The courts have repeatedly held that where a taxpayer has adopted the accrual method of accounting all income earned and liabilities incurred must be accrued uniformly in order properly to reflect the taxpayer's income. (*Aluminum Castings Co.* v. *Routzahn,* 31 Fed. (2d), 669; *Miller & Vidor Lumber Co.* v. *Commissioner,* 39 Fed. (2d), 890, Ct. D. 235, C.B. IX–2, 314; *Pittsburgh Hotels Co.* v. *United States,* 63 Ct. Cls., 475; *United States* v. *Anderson,* 269 U.S. 422, T.D. 3839, C.B.V–1, 179; *Vang* v. *Lewellyn,* 35 Fed. (2d), 283, Ct. D. 134, C.B. VIII–2, 283.)

In the instant case the taxpayer uses the straight accrual method of reporting income and the only question involved is whether a reserve credit allowed by the finance company to the dealer should be treated as income when the notes are accepted by the finance company and the reserve is credited, or whether the accrual of the income should be postponed until the purchaser of the automobile liquidates his indebtedness. It is the opinion of this office that inasmuch as the taxpayer has adopted the accrual method of accounting, he must be consistent in the treatment of all items of income. Such treatment, under the accrual method, de-

mands that each item of income shall be accrued when earned rather than when received. This is the basis upon which the theory of "accrual" is founded, and the possibility of an item of earned income not being received due to some unforeseen circumstances is immaterial. It is true that where an entry on the books of account is based on a remote contingency which may never happen such item could not reasonably be accrued for income tax purposes. (See G.C.M. 7514, C.B. IX–1, 111, relating to New York transfer tax on contingent remainders.) The contingency must, however, be something more than the mere possibility of the debtor not satisfying his indebtedness. There is always a possibility, where the relationship of debtor and creditor exists, that the debtor may not pay, due to financial reverses, but if the possibility of such failure to pay is accepted as a reason for not accruing an item of income the whole theory of the accrual method of accounting must fall where commercial transactions are concerned.

In the instant case there is just as much reason for accruing the reserve which is credited to the dealer by the finance company as there is for accruing the profit derived by the dealer as the result of the sale of the automobile. The facts show that the reserve credit is not a contingent credit but is paid to the dealer either at the time the note is liquidated by the purchaser of the car or, in case the purchaser fails to meet his obligation, the dealer is given the benefit of the reserve credit through a corresponding reduction in his liability to the finance company. It follows, therefore, that the reserve credit to the dealer is an absolute credit by the finance company and is payable to the dealer without limitation, regardless of whether the obligation is liquidated by the purchaser (who is the maker of the note) or by the dealer (who is the indorser thereof).

In view of the foregoing, it is concluded that the taxpayer, which is the retail dealer, should accrue the income in question at the time the reserve is credited to its account by the finance company.

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IN THE

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OCTOBER TERM, 1958

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

JOHN R. HANSEN and SHIRLEY G. HANSEN

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

BURL P. GLOVER

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

CLIFTON E. BAIRD and VIOLET L. BAIRD, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

MOTION OF VANCE L. WILEY AND LUCILLE J. WILEY FOR LEAVE TO FILE BRIEF AS AMICI CURIAE

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MOTION OF VANCE L. WILEY AND LUCILLE J. WILEY FOR LEAVE TO FILE BRIEF AS AMICI CURIAE

Vance L. Wiley and Lucille J. Wiley respectfully move the Court for leave to file a brief as *amici curiae*. The consent of the Solicitor General has been refused.

The applicants have an interest in these cases in that they now have pending in the Court of Appeals for the Sixth Circuit a petition for review of a decision of the Tax Court of the United States, *Vance L. Wiley, et al. v. Commissioner*, T. C. Memo. 1957-236 (presently scheduled for argument on April 21, 1959), in which the sole question involved is identical with *one* question which is *present* in one or more of these three cases, although not decided separately by the Court of Appeals in any of them, and not recognized as a separate question in the brief filed on behalf of the Commissioner of Internal Revenue.

There are two kinds of so-called "dealer reserves" (or components of one reserve, depending on the bookkeeping), one being sometimes referred to as a "holdback" and the other as a "finance reserve." From the standpoint of the money involved, the holdbacks in the three cases before the Court are of major importance. On the other hand, in applicants' case pending in the Court of Appeals for the Sixth Circuit, applicants had paid the tax on the holdbacks and are litigating only the taxability of the finance reserves.

Another case involving only the taxability of finance reserves, and not holdbacks, is *Arthur V. Morgan* v. *Commissioner*, 29 T. C. 63, now pending on petition for review in the Court of Appeals for the Ninth Circuit. Briefs and argument in this case have been postponed until decisions by this Court in the three instant cases have been rendered.

Since the taxpayers in the three cases now before this Court have little or no financial incentive (and, indeed, may regard it as contrary to their financial interest) to emphasize the distinction between holdbacks and finance reserves, which the Commissioner has ignored, applicants believe (and have been informed) that the distinction will not be adequately discussed by the parties. Nevertheless, the question is actually present on the facts, (as is recognized in Footnote 20 on page 47 of the Commissioner's brief) so that the decisions in these cases may well in-

fluence the decision in the *Wiley* case and the decision in the *Morgan* case by the Courts of Appeal for the Sixth Circuit and Ninth Circuit, respectively.

In an article entitled "New Developments in Tax Aspects of Accounting" by Arno Herzberg, CPA, 5 Journal of Taxation 280 (November, 1956), the author, after discussing holdbacks (which represent a portion of the purchase price of the automobile or trailer), says:

> "Then there is another kind of reserve. It is actually no reserve at all, although businessmen have become used to this term. It is a commission contingently credited to the dealer. Such a commission is a portion of the customer's finance charges allowed the dealer to induce him to sell contracts to the finance company. . . .
>
> "Holdbacks and reserves are thus entirely different. They involve, as we will see, quite different tax problems, although courts and authors have persistently called a reserve what was actually a holdback, and have quoted decisions on holdbacks in order to prove the taxability of reserves. In view of the many different items which accountants call reserves, it is not surprising that nonaccountants are confused."

To illustrate the confusion resulting from the failure or refusal of the parties to recognize the distinction between the two kinds of reserves, we refer the Court to page 54 of the brief filed on behalf of the Commissioner, where reference is made to a finance company's "losses arising out of defaults in, or acceleration of, the payments by purchasers." The Commissioner makes no distinction between these two kinds of so-called "losses." He assumes that a prepayment (or "acceleration" of the payment) of a note results in a "loss" to the finance company, presumably on the theory that when the principal is prepaid, the maker of the note is not required to pay the full amount of the finance charges originally included in the face amount of the note. It should be obvious, however, that this is not a true "loss" because neither the dealer, when

he receives the note from the purchaser, nor the finance company, when it purchases the note from the dealer, receives income in the amount of the unearned finance charges. The maker of the note conditionally agrees to pay them at maturity, but may avoid paying them by prepaying the principal. If income is not realized at the inception of the transaction, there is no "loss" upon prepayment, and *vice versa*.

The brief which applicants ask leave to file will be lodged with the Clerk of this Court so that it can be filed promptly if this motion is granted. The brief will present the arguments against the taxability of finance reserves from the standpoint of a dealer who is interested in that question alone and is not interested in the taxability of holdbacks.

Respectfully submitted,

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No. 380

SUPREME COURT, U. S.

No. 381

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1958

COMMISSIONER OF
INTERNAL REVENUE ..... *Petitioner*

v.

BURL P. GLOVER ..... *Respondent*

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The findings of fact and memorandum opinion of the Tax Court are not officially reported.

The opinion of the Court of Appeals for the Eighth Circuit (G.R. 36-40) is reported at 253 F. 2d 735.

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1958

COMMISSIONER OF INTERNAL REVENUE ..... *Petitioner*

v.

BURL P. GLOVER ..... *Respondent*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

QUESTION PRESENTED

The statement of the question in Petitioner's brief is improper in that it assumes the answer to the very issue before the Court. The phrase, "realizing part of their gain in cash and part in form of amounts credited to them", blithely presumes that taxpayer-dealer "realizes" gain when an entry is made on the books of the finance company.

Respondent submits that whether gain is realized is the issue to be decided here.

Respondent submits that the following represents a fair statement of the question:

Where an accrual basis taxpayer sells automobiles on a time payment basis, receiving part cash and a promissory

note for the deferred balance; and, where taxpayer sells said note to a finance company under the terms of a pre-existing contract providing for a stated discount or "reserve", and further providing that the portion of said reserve exceeding 3% of all unpaid balances of all notes sold to finance company would be paid to taxpayer; is the amount of the discount, or reserve, retained by the finance company (not in excess of 3% of note balances) taxable in the year the original reserve credit is made, or in the year in which taxpayer becomes entitled to withdraw or use it?

SUMMARY OF ARGUMENT

The taxpayer in this case is an automobile dealer reporting for income taxes on an accrual basis generally.

During all of the years involved, the taxpayer sold automobiles on a credit basis, and discounted, or sold, the notes receivable to C.I.T., under a pre-existing finance contract.

In reporting for tax purposes each year, the dealer excluded from income a portion of a reserve maintained on the books of the finance company, relying upon the finance contract. The excluded portion equalled 3% of the aggregate sum of all outstanding note balances purchased by the finance company from the taxpayer. So, the issue in the case is whether the 3% reserve so excluded should be taxed in the year in which the account entries are made.

The taxability of the total sales price at the time of sale to the customer is not in issue.

Under the express terms of the contract with the finance company, taxpayer had no rights to, or control of, the retained reserve during the taxable years involved. Taxpayer had no means at law to enforce any right to said reserve, or to have his rights declared. Even the amount of the retained reserve was subject to various contingencies which made computation of a fixed sum impossible.

The method consistently used by the taxpayer in deferring the inclusion of income from the retained reserve until he acquired the right to direct its use or withdraw it, properly, reflects his income, and is consistent with

many similar rules developed by the regulations and court decisions to meet specific business problems.

The Petitioner in brief urges reversal points to which respondent takes specific exception: namely,

That alleged administrative pronouncements have the effect of law;

That omission of gross income on the original sale is sought;

That taxpayer had constructive receipt of the retained reserve.

Whether the sale and financing are regarded as one transaction or two, the deferment of the 3% reserve under the terms of the finance contract until taxpayer acquires the right to direct its use, is a proper accounting treatment.

ARGUMENT

I

THE ISSUE IS THE INCLUSION IN INCOME OF THE PORTION OF THE DISCOUNT CHARGED BY THE FINANCE COMPANY TO WHICH TAXPAYER HAS NO PRESENT ENFORCEABLE RIGHT

Throughout his brief, Petitioner has referred again and again to the fact that at the time the customer signs the purchase agreement and note, the entire amount of the time sales price is accruable as income.

No one quarrels with such a statement, but it is not in issue in this case.

The taxpayer did not seek to exclude any part of the time price from income. The Commissioner, in his statutory notice, does not allege any such omission of income.

As stated in the statutory notice, the item in dispute is *a portion* of the discount, or "reserve", charged by the finance company upon sale of the customer's note to it.

The reserve withheld by the finance company is not identified with any part of the sales price, or the carrying charge, to the customer. The reserve is an amount reached by bargaining between finance company and dealer, governed by the terms of a written contract between them. The reserve amount in case of each sale is credited to an account on the books of the finance company. This account is a composite of all debts and credits to the reserve account, for whatever purposes, for all years, prior and current. Once the amount of the reserve on a single note is credited to the account, it loses its identity, and its ultimate payment, if ever, to the taxpayer-dealer depends on the terms of the Finance Company-Dealer Con-

tract, not upon payment or default by the particular customer.

It follows, therefore, that whether the taxpayer shall obtain a vested right to any portion of the retained reserve in any given year depends, under the contract, not upon payment or non-payment of customer notes discounted within the year, but upon the aggregate effect upon said account of the interplay of current credits and debits to the reserve and the *volume of all outstanding notes balances on which collections are being made by the finance company*, regardless of the year discounted.

The attempt by petitioner, in his brief, to twist the issue around to a question of the accruability of gross income at the moment of sale, is a distortion of his position as reflected by the statutory notice. He stated there (G.R. 10,12,14) that the entire amount credited to the reserve account during the year was taxable income. Taxpayer responded in his petition to the Tax Court of the United States (G.R. 3,4) by alleging that Respondent erred in including in taxable income the amount of the reserve account retained by the finance company under the contract.

Neither the reserve account credits, nor the retained reserve balance in each year, have any relationship to the gross income from the customer.

The retained reserve amounts to a reduction of gross income by virtue of a binding business contract between the finance company and the dealer—and the right of the taxpayer-dealer to the receipt, during the taxable year, of the 3% retained reserve, is the real issue in this case.

II

UNDER THE FINANCE CONTRACT, TAXPAYER HAD NEITHER POSSESSION OR CONTROL OF, NOR RIGHT TO, THE 3% RESERVE DURING THE TAXABLE YEAR

The agreement between the finance company and taxpayer (G.R. 23,24) provided that the finance company would purchase customer notes from taxpayer, and would withhold a reserve as set forth in the terms charts of the finance company. These terms were subject to variation from time to time, but the provisions setting up the right of taxpayer to receive the reserve remained fixed, and provided (G.R. 24):

> "Three times in each 12-month period, if we are not then indebted to you, *you will pay us our accumulated reserve in excess of 3% of the then aggregate unpaid balances on paper purchased from us.* If you stop buying our paper, you may hold and apply all reserves until liquidation of all paper purchased from us is completed" (emphasis added).

Under the express language quoted above, taxpayer had no claim to the 3% of unpaid note balance. His only claim was the right to *the excess* over said 3%. The finance company agreed only to pay the excess; taxpayer could not collect the 3%; he could not direct its application—in fact, he had no present right or interest in the 3% reserve withheld.

In this case, the taxpayer did not have an initial right to receive the reserve, which right he subsequently relinquished by agreement. Conversely, the contract was executed long before any amounts were credited to the dealers reserve, and taxpayer never at any time possessed any right to receive the 3% reserve.

> "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis,

> import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes *fixed*, the right accrues." *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182, 184, 185.

The question is not, "was C.I.T. financially able to pay the amount witheld?", as was apparently held pertinent in Brodsky, 27 T.C. No. 23, but "Did taxpayer have the right to receive it?"

Could taxpayer, at the end of 1949, have enforced a claim to the $3,885.71, representing 3% of the outstanding accounts?

The answer must be in the negative, since the contract specifically excludes the same from the obligation of the finance company to pay.

Could taxpayer *fix*, at the end of 1949, any definite amount to which he was or would become entitled? Again, the answer must be "no". The contract provides at least four specific obligations of taxpayer, unperformed at the end of the year, nonperformance of which would change the amount of the reserve withheld to which taxpayer might claim a right in the future; namely (G.R. 24,25):

(a) Obligation to purchase repossessed cars at amount equal to unpaid note.

(b) Obligation to share portion of refund of service charge, if any.

(c) Obligation under the full recourse liability in paragraph 7.

(d) Obligation to make good any deficiency incurred in resale of repossessed cars (par. 7).

As long as any of these obligations remained unperformed, the finance company could successfully resist any claim to the reserve.

There was no constructive receipt of the 3% reserve in the taxable year, because at no time did taxpayer have the right to demand payment. *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 423.

> "Whether the plaintiff (taxpayer) would ever acquire a fixed right to receive anything from the reserve fund was contingent and unascertainable throughout the taxable year". *Keasbey & Mattison Co.* v. *U. S.* (3 Cir.), 141 F. 2d 163.
>
> "It is the fixation of the rights of the parties that is controlling." *Commissioner* v. *R. J. Darnell, Inc.*, 60 F. 2d 82, 84.
>
> "Realization of a (determinate) gain is the event which calls into pay the taxing act." *MacLaughlin* v. *Alliance Insurance Co.*, 286 U.S. 244, 249.

Whether or not the dealer actually receives anything from the finance institution, from the "retained reserve", depends upon the aggregate credits to the dealer on the financing institution's books, in excess of the agreed figure (in this case, three per cent of outstanding note balances). The "retained reserve" may never reach this figure. In the case of constantly increasing sales volume, a period of years might elapse before any vested right would become fixed.

The reserve account is a composite amount, representing all credits for prior and current years, less all debits for prior and current years. The Commissioner apparently argues as if the reserve account represents the finance charge on one transaction. Actually, the reserve retained by the finance company is not the same amount as the finance charge which the customer agrees

to pay. The reserve set up by the rate schedules of the finance company, may be more or less than the finance charge, depending upon the bargaining power of the taxpayer-dealer.

The petitioner in his brief seeks to liken the "retained reserve" on the books of the finance company to an account receivable, which it is claimed the dealer should report under the accrual method of accounting. That this argument is fallacious may be clearly demonstrated by a comparison of the legal rights of a creditor to an account receivable, as compared to the legal right of the dealer to the "retained reserve".

In the instance of the account receivable, the creditor has a fixed amount due on a fixed future date, or in installments on fixed future dates. In the event of a dispute over the amount owed or the date due, the creditor may proceed in federal court and in most state courts, under Declaratory Judgment proceedings, to have the amount due and the due date declared by court order. Furthermore, such an account is readily and customarily accepted as a basis for securing commercial loans by persons engaged in heavy sales on credit.

On the other hand, the "retained reserve" on the books of the finance company does not include *any* amount which the dealer has a right to demand, nor is there any ascertainable future date at which any definite amount will become vested in the dealer. Under these circumstances, and under the terms of the contract quoted above, no court could possibly find that the dealer had a fixed right to collect any amount at any future date. It is clear that no bank or other lending institution would lend to the dealer on such collateral. In fact, the finance company is the last resort in the commercial lending field for the automobile dealer, and the finance company refuses to

guarantee a single cent to the dealer from this "retained reserve".

The argument of the Commissioner that the accrual method of accounting requires the inclusion by the dealer of an indeterminate amount, which may or may not become due on some undetermined future date, and to which the dealer has no present enforceable claim or right, is not supported by any rule of business or tax accounting.

III

THE ACCRUAL SYSTEM OF BOOKKEEPING EMPLOYED BY TAXPAYER PROPERLY REFLECTS INCOME, AND IS CONSISTENT WITH RULES ALREADY APPROVED BY THE COMMISSIONER OF INTERNAL REVENUE AND THE COURTS

The accrual method of accounting requires that the taxpayer report as income all amounts which he has the right to receive during the taxable year. However, the principle is not to be applied arbitrarily, but is to be based upon practical consideration. As was stated by the Fourth Circuit in *Blaine Johnson* v. *Commissioner*, 233 F. 2d 952, 957:

> "Taxation is a practical matter; the substance of what is done and not the form must govern."

When one examines the substance of the transactions involved in this case, he finds that the sale of new automobiles has become a particularly specialized type of business. The facts of customer financing in this country require that the automobile dealer have a constant, ready means of providing major financing to the purchaser of a new automobile. Because of the high element of risk involved and the volume of financing required, practically all automobile dealers have turned to specialized finance institutions which operate almost exclusively in financing these operations.

The result is a three-cornered transaction involving a purchaser, the dealer, and the finance institution, all of whom are necessary contracting parties to the sale of the new automobile. Long before the customer enters into negotiations for the purchase, the dealer has executed a finance contract similar to the contract which is a part of the record in this case. The finance company furnishes printed forms to the dealer and these forms are used in closing the transaction with the customer. The transaction has been well described by the U. S. Court of Appeals, Fifth Circuit, in *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395:

> "When we get down to what actually happened, at least in this case, we find one transaction—a three-cornered agreement with interrelated obligations of dealer, purchaser and finance company. Instead of being out of the first step of the transaction (the trailer sale to the purchaser), the finance company dictates the terms of the sale, has obligations running to it in the sales contract, has a fixed percentage for its finance charges worked into the sale price, and is as much a part of the substance of the business transaction as the dealer . . . (He (dealer) receives from the finance company 95% of the sales price plus a contingent claim, against the finance company, to the remaining 5%, then entirely under the dominion and control of the finance company. The dealer's claim to this 5% may never become fixed or ascertainable; it may never be received."

Furthermore, even if there are two transactions, in the first the taxpayer receives gross income, which is immediately reduced by the discount, the retained reserve, charged by the finance company.

In passing, it should be noted that the "retained reserve" provided in the contract between the dealer and the finance company is set up for the benefit and pro-

tection of the finance company, and is not an arrangement of mere convenience for the dealer, as was unfortunately held by the Board of Tax Appeals in *Shoemaker-Nash*, 41 B.T.A. 417. It certainly does not "protect" the dealer to have the finance company collect and use amounts which the dealer sorely needs in his own business. For example, if a buyer purchases realty, pays $1,000 down and agrees to pay the balance when and if title is found to be good, for whose protection is the reservation of payment? The answer is obvious, as in the instant case.

Under his method of accrual accounting, the taxpayer included all amounts which he had the right to receive during the taxable year, including the total sales prices to the customers, and excluded the "retained reserve" which he had no present right to receive. It is urged that this method properly reflects his income in each year and from year to year, and that it is consistent with the treatment presently used by other taxpayers with the approval of the Commissioner of Internal Revenue.

For example, in the identical transaction involved in the case, the finance company, as it receives the periodic payments from the purchaser, credits part of the payment to return of its principal and part to its income account. The finance company reports and pays income tax on the contract with the purchaser only as it receives the payments from the purchaser, since there is no "right to receive" any financial charges from the purchaser in the event that the purchaser prepays the contract or the automobile is repossessed. *Motor Securities Co., Inc.*, paragraph 52,136, P-H Memo Tax Court. To require the dealer to pay tax on an amount which he not only does not receive, but which the finance company refuses to promise to pay, is not in accord with any proper principles of accounting and would actually in practice lead to exhaustion of working capital of a new and growing auto-

mobile dealer. In the latter case, if the Commissioner's position were sustained, a dealer whose credit sales increased constantly over a period of years would not be entitled to recover any of the "retained reserve" under his contract with the finance company, but he would be required to pay income taxes at high rates; and the effect of this combination of circumstances would be to deplete the working capital of the business. This incongruous result is certainly not to be favored over the rational and equitable system of payment of income tax on the "retained reserve" in the year in which the dealer receives the right to collect it.

As a further example of existing regulations, recognizing the principle argued by the taxpayer in this case, we point out the Commissioner's long standing regulation with regard to "deferred-payment contracts". The present regulation is entitled "Reg. (T.D. 6314, file 9-17-58) 1.453-6, providing as follows:

> "Deferred-payment balance of real property not on installment method.
>
> (a) Value of obligations.
>
> (1) In transactions included in paragraph (b) (2) of Section 1.453-4, that is, sales of real property involving deferred payments in which the payments received during the year of the sale exceed 30% of the selling price, the obligations of the purchaser received by the vendor are to be considered as an amount realized to the extent of their fair market value in ascertaining the profit or loss from the transaction. . . .
>
> (2) If the obligations received by the vendor have no fair market value, the payments in cash or

> other property having a fair market value shall be applied against and reduced the basis of the property sold and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount thereof being the difference between the reduced basis as provided in the preceding sentence and the amount realized therefor. . . .

Under this long-standing regulation, where obligations have no market value, or where the obligations received by the seller are contingent, the seller is not required to include in income the amount of the obligations until they have been received. Even if reporting generally on accrual basis. *C. W. Titus, Inc.*, 33 BTA 928; *Burnet* v. *S. & L. Bldg. Corp.*, 288 U.S. 406.

Certainly, it is not out of step with the principle of the foregoing regulation to postpone tax on items to which the taxpayer does not even have an enforceable right, and items which have no fair market value.

Another example of similiar treatment to that requested by the taxpayer in this case, is the handling of "patronage refund credits." Recently the Court of Appeals for the Fourth Circuit held that a taxpayer on the accrual basis did not receive income through the crediting of a patronage refund credit to his account on the books of a cooperative where such credit was subject to diminution because of various contingencies contained in the agreement between the taxpayer and the cooperative. *Long Poultry Farms* v. *Commissioner*, 249 F. 2d 726. The Internal Revenue Service has announced that it will follow the various decisions which culminated in the Long Poultry Farms case. The issue involved in the patronage

refund credit cases is so similar to the situation in the instant case that it would be difficult to reconcile the Commissioner's position in resisting deferment in the one case while acquiescing in the other.

In another similar situation, the Tax Court, in the case of commission accruals to an insurance company's General Agent's account, where books were kept on accrual basis, held that the agent was not taxable on such credits until the credits were subject to petitioner's unrestricted use and enjoyment. *Leedy-Clover Realty & Ins. Co.*, 13 TC 95, 106 (1949). In that case the agent's commissions were in existence and were placed in escrow pending the passage of time until the principal had been paid for each year and until the services required by the agent had been completed. In the instant case the "retained reserve" money is actually not even in existence, but is merely represented by book entries. Future events occurring after the end of the taxable year determine whether any amount will become payable under the contract.

Still another common example of the deferment treatment urged by the taxpayer is that allowed to building contractors, allowing deferment of taxation of the 10% retained reserve held under A.I.A. standard building contracts, *Comm.* v. *Cleveland-Trinidad Paving Co.*, 62 F. 2d 85, 86 (C.C.A. 6).

IV

SPURIOUS ARGUMENTS PRESENTED BY PETITIONER

A. *Reliance on Alleged Administrative Pronouncement*

The reliance by Petitioner upon action by Congress in making "two complete revisions of the Internal Revenue Code", without making any change in the law, Cf.

Cammarano v. *U. S.*, No. 29, this term, decided February 24, 1959, is completely misplaced.

At the time of the enactment of the Internal Revenue Code in 1954, Congres is presumed to have had knowledge of all Court decisions on the question. At the time of said enactment, the controlling decision by the appellate courts was *Keasbey & Mattison Co.* v. *U. S.*, 141 F. 2d 163. This decisions sustained the position taken by the taxpayer in the instant case.

If it can be said that Congress confirmed any position in 1954, (and this may be questioned in view of absence of any specific statute on the issue) it must be assumed that they adopted the decision of the Court of Appeals, Third Circuit, not administrative letters or inferior administrative rulings.

B. *Plea that Gross Income Accrued to Dealer when Customer Signed Sales Contract and Note*

In pressing the so-called "two-transaction hypothesis", petitioner first states that the time price included a finance charge, and that a portion of the finance charge was allocated to the dealer (Pet. Brief 41,42).

Nothing in the record supports this statement.

The finance charge to the customer is not the same thing as the reserve charged to the dealer by the finance company. The Contract between finance company and dealer sets up a legal relationship involving a reserve or discount (G.R. 24, par. 4). The Contract refers separately to "Service Charge" (G. R., par. 5), which is the finance charge to the customer—a different item, not directly related to the reserve.

Perhaps this error by petitioner led him into the mistaken assumption that, somehow, this case involves some definite portion of the total price charged the customer, which the dealer seeks to omit from income (Pet. Brief, 41,47,48,50). Such is not the case. As pointed out, *supra*, page 5 of this brief, the amounts in issue are amounts constituting 3% of all outstanding note balances of all customer notes sold to finance company by dealer at any time. In no sense does this 3% amount ($3,885.71 in 1949, $7,601.07 in 1950, and $7,952.41 in 1951) (G.R. 21) represent any ascertainable portion of the sales made to customers of dealer in the then current year.

In fact, the 3% reserve under the contract could fluctuate in exactly opposite direction to the volume of current sales by the dealer.

For instance, if customer's notes owned by finance company were paid off at a faster rate than sales volume increased, the 3% retained reserve excluded from income would decline, even in the face of increased sales.

Or, if in the current year, taxpayer-dealer started carrying his own paper to a large extent, while still selling a small amount of notes to the finance company, the 3% reserve would again decline, even though sales might be static or on the increase.

Respondent urges, therefore, that regardless of two-transaction or one-transaction hypotheses, the amount of the sales price to the customer is not in issue. Rather, the real issue is the retained reserve, and the dealer's rights under the contract with the finance company. Stated simply, the question is: Is the 3% reserve excludable from gross income until the year in which dealer is entitled to control or use of it?

c. *Argument That Taxpayer Has Constructive Receipt of Full Amount of Reserve (Discount)*

At pages 53, 54 and 55 of his brief, petitioner seeks to show that the full amount of the reserve credited by the finance company to the account maintained under the Contract was taxable immediately, without any adjustment for the 3% retained reserve.

In effect, petitioner argues that the conditions in the contract which determined taxpayer's right to withdraw the full reserve were only "conditions subsequent", and amounted to the satisfaction of obligations of taxpayer.

Petitioner thus ignores the paramount condition in the Finance Company-Dealer Contract—the condition that dealer has no right to any part of the reserve below 3% of outstanding note balances. This is not only a condition precedent to the right to receive anything, but a condition precedent to the right to have anything applied to any subsequent obligation of taxpayer which might arise under the other terms of the contract.

The Contract must control in any determination of taxpayer's right to income.

Petitioner's argument really reaches the question of the *amount* of the reserve account, and not the *right* of taxpayer to any amount, as at page 55 of Petitioner's brief, where this is said:

> "It is apparent, moreover, that in any event taxpayer ultimately would receive the full amount credited to the dealer's reserve account in cash or in discharge of his obligations to the finance company."

It may be seriously questioned whether the terms of the Contract regarding *amount* may, in fact, be conditions

precedent to taxpayer's right to the 3% reserve in issue. But, even if petitioner's claim that they are conditions subsequent is given full weight, this still leaves the complete bar of par. 4 of the Contract to the *right* of taxpayer to any claim upon the 3% retained reserve.

CONCLUSION

The judgment of the Court below in case No. 381 should be affirmed.

Respectfully submitted,

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No. 512

Supreme Court of the United States

CLIFTON E. BAIRD and VIOLET L. BAIRD,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

BRIEF FOR THE PETITIONERS

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BRIEF FOR THE PETITIONERS

Opinions Below

The Findings of Fact and Memorandum Opinion of the Tax Court (R. 43-54) are not officially reported. The opinion of the Court of Appeals for the Seventh Circuit (R. 74-86) is reported at 256 F.2d 918.

Jurisdiction

The judgment of the Court of Appeals was entered on June 20, 1958. (R. 87) The time for filing the petition for a writ of certiorari was extended to and including November 17, 1958. (R. 88) The petition for a writ of certiorari was filed on November 12, 1958, and was granted on December 15, 1958. (R. 88-89) The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether amounts withheld upon assignment of installment contracts and credited by finance companies to an account designated "Dealer Reserve" in the name of petitioners, accrual basis taxpayers, are taxable as income in

the tax year when credited or in the tax year when the petitioners have the right to receive payment.

Statute and Other Authorities Involved

Printed in the Appendix, *infra*, pp. 34 through 36, are Sections 22(a), 41 and 42(a) of the Internal Revenue Code of 1939 and Treasury Regulation 118, Sections 39.41-1 and 39.41-2(a).

Statement

The sole issue in controversy involves the correct amount of accruable income for each of the taxable years 1952, 1953 and 1954 under contractual agreements between a partnership (composed of the petitioners) and three finance companies with which the partnership did business in those years. More specifically, the disputed question is whether amounts held back by the finance companies and credited to accounts on their books designated "Dealer Reserve" accounts constituted taxable income to the accrual basis partnership in the years in which such amounts were thus withheld and credited, or in the years in which the partnership had a fixed right to such amounts.

The petitioners, husband and wife, filed petitions with the Tax Court appealing from the determination of income tax deficiencies for the taxable years 1952, 1953 and 1954 by the Commissioner of Internal Revenue, aggregating $47,020.60. (R. 57) The deficiencies resulted from the Commissioner's action in taxing the partnership for its fiscal years ended February 28, 1952, February 28, 1953 and February 28, 1954, amounts thus retained by the finance companies to which it sold its installment paper. (R. 24-25) The facts, as stipulated (R. 13-22) and as found below (R. 44-54; 75-79), may be summarized as follows:

Clifton E. Baird and Violet L. Baird, the instant petitioners, are husband and wife and are also equal part-

ners in a partnership doing business under the name of "Baird Trailer Sales" (hereinafter referred to as "the partnership"). The principal office and place of business of the partnership is Salem, Indiana. The partnership was organized about January 1, 1947, and has been engaged since that time primarily in the sale of new and used mobile homes, often referred to as house trailers. The partnership has always maintained its books and records and filed its Federal income tax returns on the accrual method of accounting. It uses a fiscal year ending on the last day of February. The partnership has always deducted bad debts under the specific bad debt charge-off method. The petitioners have always filed their joint individual returns on the cash basis and on the calendar year method. (R. 13, 14)

The partnership sold most of its trailers on the installment basis; the purchaser would execute a note for the unpaid purchase price, plus insurance, interest and, in some cases, finance charges, and give a chattel mortgage on the trailer as security for the payment of the note. These notes and security instruments were executed on forms furnished by the finance companies and banks with which the partnership had arrangements to discount such paper. (R. 14-17)

Being unable to finance all of such contracts during the taxable period, the partnership assigned most of such installment contracts and notes to various finance companies and banks which specialize in this type of installment paper in order to obtain cash for working capital. Accordingly, the finance companies were able virtually to dictate the terms under which they would agree to accept the paper. During the taxable period involved, the partnership assigned such contracts and notes to only three such finance companies, namely, Minnehoma Financial Company, Tulsa, Oklahoma; Michigan National Bank, Grand Rapids, Michigan, and Midland Trailer Fi-

nance Corporation, Cincinnati, Ohio. (These companies will be hereinafter referred to separately as "Minnehoma", "Michigan" and "Midland", respectively, and collectively as "the finance company" or "the finance companies".)

As each note or contract was transferred to a finance company, the company would remit to the partnership the balance due on the selling price of the trailer, less an amount which was entered as a credit on the finance company's books to an account designated "Dealer Reserve" or "Dealer Escrow". The amount thus credited on its books and not paid over by the particular finance company was governed by the provisions of the agreement of each finance company with the partnership. The finance companies required these amounts to be withheld to protect themselves against losses. (R. 16-17)

The agreement with Minnehoma was entirely in writing.[1]

---

[1] The agreement with Minnehoma which was in effect during the taxable period involved, provided in part:

"6. The purchase price of each contract purchased by and assigned to Minnehoma hereunder shall be equal to 95% of the aggregate of the retail cash sales price of the trailercoach and all extra equipment and all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance.

"7. An amount to be determined by Minnehoma from time to time in its absolute discretion equal to not more than 5% of the aggregate of the retail cash sales price of the trailercoach and all extra equipment and all sums paid by the Dealer as required hereunder for sales and other taxes, extras and filing and recording fees less the amount of the down payment made by the purchaser in cash and/or by trade-in allowance will be credited by Minnehoma to a special reserve account in the name of the Dealer hereunder as to each contract purchased by and assigned to Minnehoma hereunder, which account will be referred to as the "Dealer Reserve Account". In addition, Minnehoma may credit to such Dealer Reserve Account hereunder, but shall not be obligated

The agreements with Michigan and Midland were principally in writing.[2]

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so to do, one-fifth (1/5) on new trailers and one-sixth (1/6) on used trailers, or such other portions as Minnehoma may determine from time to time, of the finance charge paid or agreed to be paid by the purchaser in each contract. In addition to and without affecting any or all of its rights hereunder, Minnehoma may, at its option, charge against the Dealer Reserve Account any sums that the Dealer may at any time owe to Minnehoma in any connection whatsoever. In the event and at such time or times as the Dealer Reserve Account shall exceed 15% of the aggregate unpaid balances of all contracts purchased by and assigned to Minnehoma hereunder by the Dealer plus all contingent liabilities which, on the sole determination of Minnehoma, it may have with respect to such contracts, Minnehoma will pay such excess to the Dealers from time to time as determined by Minnehoma but not more frequently than once each month. In the event that and at such time as all contracts as shall have been purchased and assigned to Minnehoma by the Dealer shall have been paid in full and no sums shall remain unpaid thereunder and in the opinion of Minnehoma there shall be no contingent liability on the part of Minnehoma with relation thereto, Minnehoma shall pay to the Dealer the balance of the credit in such Dealer Reserve Account. Minnehoma's determination as to possibility of contingent liability shall be final and not subject to question by the Dealer." (R. 46-47)

[2] The written portion of the agreement between the partnership and Michigan provided in part:

"For Valuable Consideration, the receipt of which is hereby acknowledged, the undersigned hereby sells, assigns, transfers, and conveys unto Michigan National Bank, of Grand Rapids, Michigan, its successors, and assigns forever irrevocably, all of his, its, or their right, title and interest in certain sums of money now on deposit or that may hereafter be deposited in the Michigan National Bank, of Grand Rapids, Michigan, and identified and represented by Reserve account in the name of the undersigned in the Michigan National Bank.

"This Assignment and Transfer is made as collateral security for the payment of the direct and indirect liability of the undersigned to the said Michigan National Bank of Grand Rapids, Michigan, and to secure the payment of the several notes representing said direct and indirect liability and any

Under the Minnehoma agreement, Minnehoma was authorized to hold back not more than five per cent of the sale price of a trailer and credit such amount to a special reserve account in the name of the dealer, which account

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renewal or renewals thereof, or any installment payment or payments and to secure any obligation which may arise which the undersigned may owe to said Michigan National Bank of Grand Rapids, Michigan.

"In the event of default in the payment of said liability or any installment thereof, or any of the several notes at the time when same shall fall due or in the payment of the interest thereon or any part of the principal of said liability then the Michigan National Bank, of Grand Rapids, Michigan, at their election, notice of said election being hereby expressly waived, may apply the total of said sums of money represented by said Reserve account at the date of election or any part thereof to meet the default in the liability.

"Whenever the indebtedness secured hereby is paid in full the Michigan National Bank, of Grand Rapids, Michigan, shall reassign said sums of money represented by said Reserve Account along with all right, title and interest back to the undersigned.

"If in the opinion of the bank the undersigned dealer's account is in good standing, all sums in this reserve account in excess of ten per cent (10%) of the gross unpaid balance of all contracts outstanding on February 28 of each year will promptly be returned to the undersigned dealer." (R. 47-48)

The written portion of the original agreement between the partnership and Midland is set forth in two letters, written by Midland, dated 12/3 and 12/18/1951, and providing in part:

"* * * The retail paper is to be endorsed by you with recourse.

"Our advance on new trailer paper will be 97% on the unpaid cash balance and on used trailer paper, for 95% on the unpaid cash balance. The differentials of 3% and 5% will accumulate to provide you with a loss reserve. When this reserve fund exceeds 10% of your outstandings, the excess will be paid to you automatically." (R. 49)

On and after 6/10/52, the governing portions of the agreement between the partnership and Midland were contained in a letter from Midland dated 6/4/52, which provided in part:

"Beginning on June 10, we will set up a dealer profit reserve equal to 1% of the unpaid cash balance of each retail contract. This profit reserve will be derived from the

was designated "dealer reserve account". When such account exceeded fifteen per cent of the aggregate unpaid balances of all contracts assigned to Minnehoma by the partnership, plus all contingent liabilities which, on the sole determination of Minnehoma, Minnehoma might have with respect to the purchased contracts, Minnehoma agreed to pay such excess to the partnership from time to time as determined by Minnehoma but not more frequently than once each month. When all of the contracts were paid in full and no sums remained unpaid thereunder, and in the opinion of Minnehoma there could be no contingent liability on the part of Minnehoma with respect to any such contracts, then Minnehoma would pay to the partnership the balance of the credit in such "dealer reserve account". It was agreed that Minnehoma's determination as to the possibility of contingent liability would be final and not subject to question by the partnership. In addition to the holdback provisions outlined above, Minnehoma might credit, but was not required to do so, one-tenth on new trailers and one-twelfth on used trailers, or such other portions as Minnehoma might determine from time to time, of the finance charge paid or agreed to be paid by the purchaser under each contract. (R. 46-47)

Under the Michigan agreement, the "holdback" account was credited to an account designated "dealer escrow account". The controlling payment provisions were: "If in the opinion of the bank the undersigned dealer's ac-

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service charge and it will be paid to the dealer when the retail contract is paid out.

"Effective also on June 10, the dealer reserves of 3% on new transactions and 5% on used transactions, will be paid to the dealer when the contract is paid out. This procedure will be followed on all types of payoffs, including payment by the purchaser at maturity, anticipation by the purchaser or payment by the dealer in the cases of trade-ins or repossessions." (R. 49)

count is in good standing, all sums in this reserve account in excess of ten per cent (10%) of the gross unpaid balance of all contracts outstanding on February 28 of each year will promptly be returned to the undersigned dealer." (R. 47-48)

The original Midland agreement was basically the same as the Minnehoma agreement, except that under the Midland agreement when the dealer reserve account exceeded ten per cent, instead of fifteen per cent, payments to the partnership were to be made in accordance with the agreement. Under an amendment to the Midland agreement effective June 10, 1952, a dealer profit reserve account was set up on the books of Midland to credit an amount equal to one per cent of the unpaid cash balance of each contract to be derived from the service or finance charge. No amounts were to be paid to the partnership under this provision until each retail contract was completely paid out. Furthermore, under this 1952 amendment, the "holdback" amounts of three per cent on new trailer sales and five per cent on used trailer sales, would be paid to the partnership when the contract was paid out, rather than when a minimum balance was achieved. (R. 49-50)

The agreements of the partnership with each of the three finance companies contained the following common provisions:

(a) In the event the retail purchaser's contract became due and unpaid, the finance company could charge the account of the partnership designated "Dealer Reserve" with the unpaid balance, as well as with repossession losses;

(b) In the event the partnership had a matured financial obligation of any nature to the finance companies, the amount of such obligation could be charged to the partnership's account designated "Dealer Reserve"; and

(c) Each finance company could look to the balance in the account designated "Dealer Reserve" of the partnership to satisfy any default by the partnership on its guarantees and obligations to the finance company, as well as any default by the makers of the notes. (R. 17)

A typical trailer sale transaction is illustrated as follows:

Sales Price of Trailer	$ 5,545.00
Cash Down Payment (and/or Trade-in Allowance)	1,745.00
Balance Due Baird Trailer Sales	$ 3,800.00
VSI (Skip Insurance)) Credit Check) Insurance)	$ 420.00
Principal (Amount of Note)	$ 4,220.00
Financing Charges Paid to Finance Company	420.00
Balance Due Baird Trailer Sales	$ 3,800.00
Credited to Reserve of Baird Trailer Sales	190.00
Cash Paid Baird Trailer Sales by Finance Company	$ 3,610.00

(R. 18)

During the taxable years 1952, 1953 and 1954 the partnership received and reported in taxable income the respective total amounts of $1,217.94, $1,778.94 and $9,-141.39 from the finance companies out of the Dealer Reserve accounts. Such amounts were paid in part by Minnehoma, Michigan and Midland, and the remainder by companies with which the partnership formerly had done business, but with which it did no new business in 1952, 1953 and 1954. The total amounts withheld and credited to the Dealer Reserve account by Minnehoma, Michigan and Midland during 1952, 1953 and 1954 were $25,816.58, $29,560.54 and $29,660.49. In determining the instant tax deficiencies, the Commissioner reduced such total credits by the aforesaid reported amounts and thereby added

the respective net amounts of $24,598.64, $27,781.61 and $20,519.18 to taxable income of the partnership for 1952, 1953 and 1954. (R. 22)

During the years here involved, the partnership (by way of illustration) recorded the sale of a trailer and the sale of the note on its books and records as follows:

Sales Receipt Journal Entry.

Cash and/or Trade-in Allowance	$1,745.00	
Contracts Receivable—Finance Company	3,800.00	
Trailer Sales		$5,545.00

When the Finance Company remitted the check, the following entry was made:

Reserve—Finance Company	$ 190.00	
Cash	3,632.67	
Expense for Intangible Stamps	1.38	
Contracts Receivable—Finance Company		$3,800.00
Expenses (Credit Check)		24.05
Cost of Sales		$3,824.05
Cost of Sales	$3,824.05	
Credit Inventory		$3,824.05

From the date of organization throughout the years involved, the partnership was at no time delinquent in any payments due the finance companies and most of the trailer purchasers were paying their notes when due.

On its returns for the taxable years 1952, 1953 and 1954, the partnership deducted specific bad debts in the respective amounts of $1,203.75, $2,239.12 and $1,203.69. Unpaid amounts due the partnership for accessories, supplies and repairs constituted a portion of such deductions. The remainder consisted of advances by the partnership to make the trailer purchaser's payments due a finance company under the conditional sales agreement which the purchaser failed to make.

When a purchaser defaulted on his contract and note, the trailer was repossessed upon receipt of notice of default. The partnership always paid the finance company the unpaid balance due on such note and recorded

such payment on its books and tax returns as a purchase. Where defaults occurred on the notes payable to the partnership, the payments to the finance companies as a result of the defaults were included on the partnership's fiscal year 1952, 1953, and 1954 returns as part of cost of goods sold. On resale of the repossessed trailer, the receipts therefrom were reported as gross receipts.

During the years here involved, the finance companies were in such good financial condition that they were able to pay any accounts which might have been due and payable to the partnership out of the Dealer Reserve accounts.

As of February 28, 1952, 1953 and 1954, the accumulated balances in the accounts designated below and the amount unpaid on notes signed by the purchasers of the trailers and sold with recourse to the several finance companies were as follows:

Minnehoma Financial Company

	"Dealer Reserve Account"	*Unpaid Balance*
February 28, 1952	$16,311.73	$224,677.16
February 28, 1953	21,279.30	207,346.78
February 28, 1954	25,438.69	185,398.65

Michigan National Bank

	"Dealer Escrow Account"	*Unpaid Balance*
February 28, 1952	$20,187.55	Unavailable
February 28, 1953	18,993.01	$ 94,930.14
February 28, 1954	19,218.03	92,577.49

Midland Trailer Finance Corporation

	"Dealer Reserve Account"	*Unpaid Balance*
February 28, 1952	$ 3,572.39	$ 93,043.00
February 28, 1953	28,347.95	650,000.00*
February 28, 1954	39,065.43	760,879.00

* This figure is an approximation furnished by the corporation in letter dated April 18, 1957, since it made no analysis of unpaid notes as of February 28, 1953.

SUMMARY OF ARGUMENT

Income does not accrue until the right to receive an amount becomes fixed. The amounts withheld by finance companies and credited to Dealer Reserve accounts on its books are not accruable in the year of withholding because extreme contingencies rendered most uncertain the right of the petitioners to such amounts.

The agreements between the partnership and each of the finance companies severely restricted the right of the petitioners to the amounts withheld. Although each agreement had slight variances, all three agreements were identical in their basic provisions. The crucial provision of each agreement permitted payments to the petitioners only when the balance in the Dealer Reserve account exceeded a fixed percentage of the total unpaid amount on all the trailer contracts, or, under one agreement, until the particular trailer contract was paid out. Other restrictions in the agreements, such as the absolute right of the finance company to charge against the account any claims against the partnership, cause the withheld amounts, and the credited portion of the finance charge, to be within the control of the finance companies and, therefore, not accruable by the partnership.

The holdback and other restrictive provisions of these agreements were dictated by the finance companies to protect themselves against losses. The partnership was forced to acquiesce in these unfavorable terms in order to do business with the finance companies.

The credits in the Dealer Reserve accounts were not partnership assets.

Trailer contracts and notes were assigned by the partnership solely because of its immediate needs for cash funds, since the business would have been much more profitable if the partnership had been financially able to retain such paper.

ARGUMENT

Baird Trailer Sales, a partnership, correctly accrued and reported in taxable income the amounts to which it was entitled under its agreements with finance companies which had purchased its installment contracts and notes.

The sole issue in controversy is whether amounts withheld by finance companies acquiring installment paper from the partnership, of which the instant petitioners were the sole partners, and credited to accounts designated "Dealer Reserve" on the books of the finance companies, pursuant to agreements between the companies and the partnership, should be accrued as taxable income by the partnership (a) in the years in which the partnership became entitled to such amounts under the terms of the several agreements, as contended by the petitioners, or (b) in the years in which such amounts were so withheld and credited, as contended by the respondent. In certain instances a portion of the finance charge was credited to such "Dealer Reserve" accounts in addition to the withheld amounts.

A. *Income Does Not Accrue Until the Right to Receive an Amount Becomes Fixed.*

Under Sections 41 and 42 of the Internal Revenue Code of 1939, the accrual system of accounting has been recognized as a proper method of accounting for income. The instant partnership utilized this method.

It has long been well-settled that it is the right to receive and not the actual receipt that determines the year for inclusion of the amount in gross income under the accrual method. This principle was enunciated in the case of *Spring City Foundry Company* v. *Commissioner*, 292 U.S. 182, and also in the earlier case of *North American Oil Consolidated* v. *Commissioner*, 286 U.S. 417.

This principle has been uniformly applied in subsequent cases. Representative decisions include *Campana Corporation* v. *Commissioner*, 210 F. 2d 897 (C.A. 7th), *Albers* v. *Reinecke*, 92 F. 2d 781 (C.A. 7th), and *Commissioner* v. *Edwards Drilling Co.*, 95 F. 2d 719 (C.A. 5th).

In the more recent cases of *Dixie Pine Products Co.* v. *Commissioner*, 320 U.S. 516 and *Security Flour Mills Co.* v. *Commissioner*, 321 U.S. 281, this Court reaffirmed the rule announced in its earlier accrual cases. Although these latter cases involved the accrual of deductions, rather than the accrual of income, the principles governing the year of accrual are basically the same. As this Court said in the *Security Flour Mills Company* case: "It is the year in which the right to receive has become final and definite in amount that becomes the proper year of accrual." Furthermore, a "strained construction in administrative efforts to accrue income, should be avoided." *Commissioner* v. *Edwards Drilling Co., supra.*

B. *The Amounts Withheld by the Finance Companies Are Not Taxable in the Year Thus Withheld Because the Partnership Had No Fixed Right to Such Amounts in View of the Extreme Contingencies Governing the Payment of Such Amounts to the Partnership.*

During the taxable period involved, the partnership assigned deferred payment paper to only three finance companies, namely, Minnehoma Financial Company, Michigan National Bank, and Midland Trailer Finance Corporation. Although the agreements between the partnership and these three finance companies had slight variances, they were substantially equivalent in their general provisions. The petitioners contend that, under all three agreements, the right of the partnership to the amounts withheld from the purchase price of notes was so contingent during the taxable period that such amounts

should not be accrued as taxable income in the years withheld by the companies. (The Commissioner has not contended that the three agreements are distinguishable.)

The agreements with all three finance companies contained the following common provisions:

(a) In the event the retail purchaser's contract became due and unpaid, the finance company could charge the account of the partnership designated "Dealer Reserve" with the unpaid balance;

(b) In the event the partnership had a matured financial obligation of any nature to the finance companies, the amount of such obligation could be charged to the partnership's account designated "Dealer Reserve";

(c) Repossession losses of the finance companies could be charged to the account of the partnership designated "Dealer Reserve";

(d) The ultimate balance in the account of the partnership designated "Dealer Reserve" after payment of all notes by the partnership to the finance companies was to be paid to the partnership; and

(e) Each finance company could look to the balance in the account designated "Dealer Reserve" of the partnership to satisfy any default by the partnership on its guaranties and obligations to the finance company, as well as any default by the makers of the notes. (R. 17)

It is clear that each of these agreements wraps in one tight package the dealer's sale of a trailer contract to the finance company. Each agreement orbits around two central purposes: (1) the intention of the finance company to control the trailer sales, and (2) the intention of the finance company to have discretionary authority over the "Dealer Reserve" account in which the partnership had only a restricted contingent interest, subordinate to certain conditions in favor of the finance company. An

analysis of each finance company's agreement with Baird Trailer Sales clearly discloses the ultimate fact that the partnership had no fixed right to the withheld amounts during the taxable period.

1. *The Minnehoma Agreement.*

The agreement provides that Minnehoma will finance only Spartan Aircraft Trailers. The trailer purchaser must complete a credit form supplied by Minnehoma; the dealer forwards this and two copies of a Dun & Bradstreet or Retail Merchant's Credit Report to Minnehoma. Each trailer contract must be on a printed form provided by Minnehoma. Both the financing agreement and the trailer sale contract provide that the balance owed by the purchaser is payable at the Minnehoma Office in Tulsa, Oklahoma. No payments are to be made to the dealer, except, of course, the down payment. Any other payments the dealer receives are held in trust for Minnehoma and must be forwarded immediately to Minnehoma. Minnehoma designates the amount of the down payment. (R. 27-35)

The purchaser may sign only one trailer purchase contract, and this contract must be delivered to Minnehoma. The dealer's assignment and guarantee to Minnehoma is on the face of the trailer sales contract. Minnehoma has the right to pursue collection efforts and to repossess trailers on delinquent accounts, or to call upon the dealer to do so, all expenses to be borne by the dealer. The trailer contract includes an unconditional guarantee by the dealer against any losses by Minnehoma, including loss of prospective profits. The purchaser executes no notes in favor of the dealer and no evidence of the sale is obtained except the original trailer contract forwarded to the finance company. After deduction of the down payment in cash or by trade-in allowance, two elements make up the amount the purchaser pays: (1) the selling price of the trailer, and (2) a finance charge, usually

five percent on new trailers and six percent on used trailers per year on the selling price less the down payment.

Under the agreement between Baird Trailer Sales and Minnehoma, the trailer sale contract must provide that the purchaser pay in monthly installments over a period of not more than sixty months for new trailers and thirty-six to sixty months for used trailers, the exact period depending upon the model. The "purchase price of each [trailer] contract purchased by and assigned to Minnehoma" is ninety-five percent of the balance of the purchase price of the trailer. Minnehoma agrees to reimburse the dealer for sales taxes, extras, filing and recording fees.

As to the hold-back, the agreement provides that "An amount to be determined by Minnehoma from time to time in its absolute discretion equal to not more than five percent" of the aggregate purchase price "will be credited by Minnehoma to a special reserve account in the name of the Dealer." No payments are to be made to the dealer from the reserve account until the total in the account exceeds fifteen percent of the aggregate unpaid amount on all the trailer contracts, plus an amount adequate to satisfy any contingent liability which Minnehoma, in its absolute discretion, might determine to be due on such contracts. There is a further limitation upon payment, in that the excess amounts are payable only *"from time to time as determined by Minnehoma."* (Emphasis supplied.)

In addition to the hold-backs in the reserve, Minnehoma *may* credit the partnership with a portion of the finance charge, a matter solely within the discretion of Minnehoma, there being no obligation to make such credits. It is subject, of course, to the same conditions as the hold-back, once it is credited to the dealer's reserve account. (R. 27-35)

In addition to the uncertainty created by Minnehoma's discretionary authority to withhold amounts adequate to satisfy any contingent liability, the contract sets forth other conditions which cumulatively, if not separately, make the dealer's claim to the reserve contingent or unfixed. For example, "Minnehoma may, at its own option, charge against the Dealer Reserve account any sums that the dealer may at any time owe to Minnehoma in any connection whatsoever." (R. 32) Under this provision, Minnehoma conceivably might charge against the account court claims, fanciful breach of contract claims, and claims having no connection with the specific amounts in the Dealer Reserve account. In other words, under this broad provision, Minnehoma might charge against the account claims for which Baird Trailer Sales might or might not be liable.

Moreover, even when all the trailer contracts have been paid in full, Minnehoma may still refrain from turning over to the dealer the amount in the reserve account until "*in the opinion of Minnehoma* there shall be no contingent liability on the part of Minnehoma with relation thereto," that is, on the trailer contracts. (R. 32) "Minnehoma's determination as to the possibility of contingent liability shall be final and not subject to question by the dealer." (R. 32)

Finally, the dealer unconditionally guarantees the payment of the entire amount on each trailer contact, which would include sums due on contracts the terms of which may be extended and altered by the finance company. On a trailer purchaser's default, the dealer agrees to pay the sum due or, upon Minnehoma's demand, to repurchase the contract for the entire amount unpaid under the contract. Since the unconditional guarantee includes the five percent reserved, insurance premiums for the full term, and the finance charge for the full term, the dealer guarantees the finance company against all loss, includ-

ing loss of anticipated profits. Thus, it is clear that under the basic agreement the dealer guarantees considerably more to the finance company than is withheld in the reserve on the sale. For example, at the close of the taxable year ended February 28, 1952, the amount of the Dealer Reserve account with Minnehoma was $16,311.73, whereas the total of the unpaid balances on the contracts of the purchasers of trailers was $224,677.16. The comparable figures for the fiscal years 1953 and 1954 are $21,279.30 in the Dealer Reserve account as compared to $207,346.78 of unpaid balances, and for the fiscal year 1954, the comparable amounts are $25,438.69 and $185,398.65. (R. 20-21) Hence, the partnership's obligations to Minnehoma by contract precluded the partnership from asserting any right to the amounts withheld and credited to the Dealer Reserve account during the taxable period involved.

It is thus apparent that on the credit sale of a house trailer, the purchaser, dealer and finance company each have obligations which are interwoven in a single three-party agreement. This agreement gives the finance company virtually complete control over a fixed percentage, usually five percent, of the unpaid purchase price. The finance company exercises its control by withholding this fixed percentage in a special Dealer Reserve account surrounded by various conditions precedent to payment. These conditions are contingencies which might bar indefinitely the dealer's right to receive payments from the account and which did, in fact, bar that right at all times during the taxable period when the amount in the account was below the required percentage.

2. *The Michigan National Bank Agreement.*

Although containing less detail in its provisions, the agreement between Baird Trailer Sales and Michigan National Bank is fully as restrictive as the agreement with Minnehoma. The Michigan National Bank agree-

ment provides that in the event of default in the payment of any installment of the purchase price, or any of the notes given by the trailer purchaser, the Michigan National Bank at its election has the option of applying the total of the amounts in the Dealer Reserve account to meet the default in the purchaser's liability. The agreement also provides that when the indebtedness is paid in full, Michigan shall reassign the amounts represented in the Dealer Reserve account to Baird Trailer Sales. The agreement also provides that "*If in the opinion of the bank the undersigned dealer's account is in good standing,* all sums in this reserve account in excess of ten percent (10%) of the gross unpaid balance of all contracts outstanding on February 28 of each year will promptly be returned to the undersigned dealer." (Emphasis supplied.) (R. 37-38)

It is thus seen that the Michigan agreement is fully as restrictive upon Baird Trailer Sales as its agreement with Minnehoma. The variances in minor details between the two agreements are of no importance in resolving the question of whether amounts withheld by the two finance companies must be accrued in the years of withholding.

3. The Midland Agreement.

Likewise, the agreement with Midland Trailer Finance Company contains similarly restricting provisions limiting the partnership's right to receive the amounts withheld by the finance company, plus the portion of the finance charge which were credited to the Dealer Reserve account, so that such amounts are not accruable in the year thus withheld, but only the amounts to which the partnership was entitled to receive, and did receive, during the years 1952, 1953 and 1954.

The original Midland agreement was dated December 18, 1951, and was set forth in a letter from Midland to

Baird Trailer Sales. One of the key provisions of the agreement reads as follows: "Our advance on new trailer paper will be for 97% on the unpaid cash balance and on used trailer paper, for 95% on the unpaid cash balance. The differentials of 3% and 5% will be accumulated to provide you with a loss reserve. When this reserve fund exceeds 10% of your outstandings, the excess will be paid to you automatically." (R. 39-40).

On June 4, 1952, Midland modified the above-quoted provision as follows:

> "Beginning on June 10th, we will set up a dealer profit reserve equal to 1% of the unpaid cash balance of each retail contract. This profit reserve will be derived from the service charge and it will be paid to the dealer when the retail contract is paid out.
>
> "Effective also on June 10th, the dealer reserves of 3% on new transactions and 5% on used transactions will be paid to the dealer when the contract is paid out. This procedure will be followed on all types of payoffs including payment to the purchaser at maturity, anticipation by the purchaser or payment by the dealer in the cases of trade-ins or repossessions." (R. 41)

In other words, under the modified agreement, the holdback in the Dealer Reserve account, plus the portion of the finance, or "service" charge, was to be paid to the dealer when the contract was completely paid out, rather than when the reserve fund reached a specified percentage of outstanding dealer liability. Hence, it is the petitioners' position that the basic controlling provisions of the partnership agreements with all three finance companies are identical for the purpose of resolving whether the withheld amounts are accruable in the years of withholding; the respondent does not contend to the contrary.

4. The Controlling Contingencies Prevent Current Accrual.

Under the rule that taxation is chiefly concerned with the substance, rather than the form, of the factual pattern involved, it is clear that the withheld amounts were not within the dominion and control of petitioners during the taxable period, except as to the amounts received from the finance companies, which have been reported in taxable income. The position of the Commissioner is the embodiment of "attenuated subtleties," an approach frequently rejected by this Court in numerous income tax cases.

As so well stated in *United States* v. *Maryland Jockey Club*, 210 F. 2d 367 (C.A. 4th):

> "* * * Federal income taxes are based on reality not form, on fact not fancy, on substance not seeming. * * *"

To accrue currently the amounts withheld by the finance companies, as respondent contends should have been done, would be to exalt artifice over reality. Such accrual would depart from the well-settled principles governing accrual of income.

Petitioners' position on this issue was adopted, and the Tax Court's view was rejected, in the first opinion of a Court of Appeals wherein this precise question was considered. In *Johnson* v. *Commissioner*, 233 F. 2d 952 (C.A. 4th), the factual situation was identical in all material respects with the factual situation here. As in this case, the taxpayer there was a trailer dealer, and two of the finance companies with which he did business during the taxable period were Minnehoma and Michigan National Bank under agreements which were identical with the agreements between Baird Trailer Sales and these two finance companies. In both cases, the finance companies credited reserves on their books to the credit

of the dealer and withheld the amounts of the credits from the dealer. In both cases the Commissioner sought to include such withheld amounts as accruable income in the years withheld.

In the *Johnson* case, *supra*, the Court of Appeals for the Fourth Circuit reviewed the various decisions dealing with the proper year of accrual of income under circumstances which most nearly approximated those of trailer dealers. As pointed out by that Court: "No case involving reserves withheld by finance companies from a trailer dealer or an automobile dealer has been decided by any United States Court of Appeals." (233 F. 2d at 957.)

The court thereupon gave consideration to the various cases which had dealt with accrual problems under similar circumstances in the following language:

> "These principles have been applied by other courts and by this court to postpone the accruability of various types of reserves where the taxpayer's right to receive the money was dependent upon some contingency: *Commissioner* v. *Cleveland-Trinidad Paving Co.* (6 Cir.), 62 Fed. (2d) 85 (percentage of the contract price for street paving retained under contract provisions by municipalities to guarantee maintenance of the paving for a stipulated period); *Keasbey & Mattison Co.* v. *U. S.* (3 Cir.), 141 Fed. (2d) 163 (reserve withheld by a finance company from an asbestos manufacturer which had guaranteed home owners' notes discounted by the finance company for applicators of the taxpayer's product); *U. S.* v. *Fidelity & Deposit Co.* (4 Cir.), 177 Fed. (2d) 805, 178 Fed. (2d) 753 (reserves required by law to be set up against unearned premiums and losses on risks reinsured with another company not authorized to do business within the state); and authorities cited in those opinions." (233 F. 2d 956, 957)

The Court of Appeals for the Fourth Circuit held that dealers' reserves are not taxable income until there is a

fixed right to receive them and that the fixed right did not arise until the year in which they became payable to the dealer in accordance with his contract with the finance company. The court further held that the right of the taxpayer to receive the amounts in the Dealer Reserve account was not fixed in the fiscal year when the amounts were withheld by the finance company.

The Court stated that "The pattern of each sale was a single transaction from the time the trailer was sold through the time the note was discounted by the particular finance company on whose forms it was executed."

Subsequent to the opinion in the *Johnson* case, *supra*, the Court of Appeals for the Fifth Circuit sustained the taxpayer in *Texas Trailercoach, Inc.* v. *Commissioner*, 251 F. 2d 395 (C.A. 5th). The factual situation there was identical with the instant factual situation is so far as the Minnehoma agreement is concerned. Since no basic distinctions exist between the Minnehoma agreement and the Michigan and Midland agreements, this decision is squarely in point with the instant case. The Court held in the *Texas Trailercoach* case, *supra*, that the amounts in the Dealer Reserve account were contingent credits and, therefore, that they did not accrue in the taxable year when the finance company withheld them and credited them on its books to the taxpayer.

In reaching its decision, the Court used the following cogent language:

> "The closer a tax comes to giving effect to the economic realities, the more bearable it is as the price of national security and of civilization. *The real trouble in this case is that the taxpayer is asked to pay a tax on money he did not in fact receive and had no right to receive during the taxable year in question.* He may never receive it, but he is asked to deplete his cash in order to pay it. If compelled to pay, the more business he does—the worse off his cash position will be. *But, if a more realistic view*

is taken, the Government will not be deprived of any tax, because when the contingent credit materializes as a fixed, ascertainable claim or if payments are received from the reserve account, the taxpayer must then include the fixed claim or payments in his taxable income." (Emphasis supplied.) (251 F. 2d 403, 404)

As the Court pointed out in the *Texas Trailercoach* case, the finance company played a vital part in the transaction from the incipiency of each trailer sale. In effect, the finance company controlled each sale, passed on the credit risk, furnished the printed form, dictated the terms of each trailer sale, and was specifically designated as the party to receive the unpaid balance. As far as the trailer purchaser knew or cared about the transaction, his dealings were with the finance company from the moment the sale was executed. As the Court pointed out; "In a real sense, Minnehoma extended its credit to the trailer purchasers, and purchased the trailer contracts *for* the trailer purchasers, at least to the same extent that Bancredit Corporation 'merely discounted notes for applicators' in *Keasbey & Mattison* v. *Commissioner.*"

The court also pointed out that the finance company in truth and in fact exercised dominion and control over the amount held back from the purchase price and to which the trailer dealer was not entitled during the taxable year. As the Court stated:

> "The practical effect of Minnehoma being a party to the transaction from the beginning, is that the taxpayer did *not* receive the full sales price or its equivalent from the purchaser. Minnehoma stepped in and exercised dominion and control over five per cent. The Commissioner is mistaken in saying that the taxpayer in any event receives the full sales price and that the only risk is the risk in every credit sale that the trailer purchaser may default. Here, the taxpayer runs the risk that Minnehoma, ex-

> ercising complete discretionary control over the reserve account, 'at its opinion', may charge against the account amounts Minnehoma decides that the dealer may at any time owe in '*any connection whatsoever*', a determination that is not subject to question by the dealer."

The Court of Appeals for the Fifth Circuit emphasizes the illusory nature of the dealer's position by its statement that "The dealer does not have a fixed, ascertainable claim to the reserve at the time of the sale or holdback; he has a claim for some time in the future." Likewise, petitioners here had nothing more definite than a claim for some time in the future.

The case of *Keasbey & Mattison Co.* v. *U. S.*, 141 F. 2d 163 (C.A. 3d), is also applicable here, although its facts are not identical. In that case a reserve had been withheld by a finance company from an asbestos manufacturer which had guaranteed home owner's notes discounted by the finance company for applicators of the taxpayer's product. Specifically, the taxpayer had discounted notes receivable with a finance company for a charge of 7%, 2% of which was to be credited to a reserve account to be used in paying off discounted notes which were more than 60 days delinquent. The taxpayer assumed a maximum liability of 10% of the paper discounted and was entitled to receive annually the excess over its guaranty remaining in the reserve fund, as well as the balance remaining in the fund upon termination of the agreement. Thus, it is readily apparent that the basic provisions of this agreement are substantially equivalent to the basic provisions of the instant petitioners' agreements with Minnehoma, Michigan and Midland.

In *Keasbey & Mattison Co.*, *supra*, the court held that no part of the reserve was accrued income of the taxpayer during the taxable year involved. It was stressed that whether the taxpayer would ever acquire a fixed right to receive anything from the reserve fund was con-

tingent and unascertainable throughout the taxable year. Likewise, in the instant proceeding, whether the taxpayer would ever acquire a fixed right to receive anything from the accounts designated "Dealer Reserve" account was contingent and unascertainable throughout the taxable year, except for the amounts actually received from the companies. Such amounts, of course, were reported in taxable income. The court also stressed that the "reserves" credited on the books of the finance company could be diminished by charges against them for delinquent and unpaid notes. The same factual situation is present in the instant case.

The Circuit Court of Appeals for the Eighth Circuit and for the Ninth Circuit have joined the Third, Fourth and Fifth Circuits in rejecting this general position of the Commissioner and the Tax Court, *Glover* v. *Commissioner*, 253 F. 2d 735 (C.A. 8th) and *Hansen* v. *Commissioner*, 258 F. 2d 585 (C.A. 9th); whereas the Court of Appeals for the Sixth Circuit has joined the Court of Appeals for the Seventh Circuit in sustaining the Tax Court's view. *Schaeffer* v. *Commissioner*, 258 F. 2d 861 (C.A. 6th).

Petitioners urge that the basic weakness in respondent's position is his failure to evaluate adequately the degree of contingency to which the credited amounts are subject. Respondent correctly states that "What is a substantial contingency is basically a question of degree." (Commissioner's Brief, 54)

How substantial is the contingency; how seriously does it interfere with the domination over the income or true ownership therein? It has been held that a sufficient contingency existed to prevent accrual in the taxable year in the following cases: payments received, in 1930 and 1931, under an option to purchase property, which were to be applied upon the purchase price in case the option was exercised but which were to be retained in case the

option was not exercised, where the option was surrendered in 1933 (*Commissioner* v. *Virginia Iron Coal and Coke Co.*, 99 F. 2d 919 (C.A. 4th), cert. den. 307 U.S. 630); deposits received over a three-year period by the seller under an option for the purchase of stock where the option was forfeited at the end of the period (*Hunter* v. *Commissioner*, 140 F. 2d 954 (C.A. 5th)); payments received in connection with an option agreement where the nature of the payments, as purchase price or rent, could not be determined until a later year (*Birch Ranch and Oil Co.* v. *Commissioner*, 152 F. 2d 874 (C.A. 9th), cert. den., 328 U.S. 863); and advance payment upon the sale of real estate where the sale was subject to forfeiture in a subsequent year (*Baird* v. *United States*, 65 F. 2d 911 (C.A. 5th), cert. den., 290 U.S. 690).

Petitioners earnestly urge that the restrictive control of the finance companies over the withheld amounts was truly substantial, not fleeting or fanciful. These amounts were unavailable to the petitioners during the taxable period. Whether they would ever be available was extremely uncertain. The wide control possessed by the finance companies rendered petitioners' current income rights most doubtful. *Johnson* v. *Commissioner, supra; Texas Trailercoach, Inc.* v. *Commissioner, supra.*

It is petitioners' position that each trailer sale, execution of retail paper, transfer of the paper and entry of credits to a Dealer's Reserve account constituted a "single three-cornered arrangement involving the dealer, the purchaser, and the finance company." *Hansen* v. *Commissioner, supra.* The record is abundantly clear that the finance company was an integral part of the original sale transaction and that, clearly, the partnership could not have carried on its business unless the finance companies had furnished the necessary financing by purchasing its retail paper. Since respondent states in his brief (40-41) that "either approach [single-trans-

action hypothesis or two-transaction hypothesis] should lead to the same tax result," no further discussion of this point is deemed necessary.

It is also significant that the accrual-basis finance company pays income tax on the purchaser's contract only as it receives the payments from the purchaser, since there is no "right to receive" any finance charges from the purchaser in the event the purchaser prepays the contract or the item is repossessed. *Motor Securities Co., Inc.*, unreported memorandum opinion of the Tax Court of the United States, dated October 30, 1952.

In a related case, it has been held that a taxpayer on the accrual basis did not receive income through the crediting of a patronage refund credit to his account on the books of a cooperative where such credit was subject to diminution because of various contingencies specified in the agreement between the taxpayer and the cooperative. *Long Poultry Farms* v. *Commissioner*, 249 F. 2d 726 (C.A. 4th). The Commissioner has announced that he will follow the court decisions culminating in *Long Poultry Farms* v. *Commissioner, supra.* Rev. Rul. 57-358, 1957-2 C.B. 42. The issue involved in that case is almost identical with the issue in the instant case.

C. *The Holdback and Other Restrictive Provisions of the Agreements with the Finance Companies Were Dictated by Such Companies in Order to Protect Themselves from Any Losses.*

The terms of the various agreements with the finance companies were entirely forced upon Baird Trailer Sales by such companies. There was no opportunity for negotiation on the part of the partnership in order to bring about more favorable terms in such agreements. Mr. Baird testified that he had no opportunity to make any suggestions with respect to the provisions which should be contained in his agreement with the finance companies.

(R. 22-23) The partnership had no choice but to accept the company's terms if it hoped to discount its paper in order to obtain the cash most urgently needed in its business.

A vice-president of Midland testified that the hold-back provisions were inserted in the contracts with Baird Trailer Sales in order to protect Midland against any losses. (R. 26-27) An officer of Minnehoma testified to the same effect in the *Johnson* case, *supra*. Further, the agreements clearly reflect that the partnership was at the mercy of the finance companies in the arrangements which are involved in the instant case. The extreme contingencies with respect to the payments of amounts back to Baird Trailer Sales were created by the finance companies for their protection, not by Baird Trailer Sales.

It is obvious that the high risk element in the sale of house trailers severely limited the market for trailer coach paper and gave heavy bargaining leverage to financing institutions. As a result, the finance companies have come to exercise considerable control over a dealer's business practices and frequently participate in and police a dealer's sales.

D. *The Credits in the Dealer Reserve Accounts Were Not Assets of the Partnership.*

The credit balances in the Dealer Reserve accounts did not constitute assets of the partnership. The balance sheets of the partnership as reflected in its Federal income tax returns do not set forth the credit balances as assets. Furthermore, Clifton E. Baird, one of the petitioners, testified that he did not consider the balances in the Dealer Reserve accounts to be assets of the partnership and he did not include such balances in the financial statements of the partnership as prepared under his supervision and made available to appropriate

agencies, such as banks and other credit agencies, including Dun & Bradstreet. (R. 24-25)

From time to time the finance companies requested statements of the amounts of the balances in such accounts and also the amounts of the contingent liabilities of the partnership on notes and contracts sold to finance companies. When such information was requested, the partnership, of course, furnished it in order to continue to do business with the requesting company. Even when furnished to a finance company upon request, the credit balances were not reflected as assets in the balance sheet, but were only mentioned in a separate accompanying statement.

E. *Trailer Contracts and Notes Were Discounted by the Partnership Solely Because of Its Need for Immediate Funds.*

The helplessness of the partnership in its relationship with the finance companies is emphasized by the fact that the discounting of contracts and notes took place only because the partnership was in pressing need of funds. Mr. Baird testified that he would not have assigned any contracts or notes except that he urgently needed working capital in order to go forward with his business. (R. 23) The instant petitioners apparently were typical members of the new and growing trailer-dealer industry, who were experiencing an acute shortage of working capital in their efforts to survive and expand. The Commissioner's position would actually cause the dealer's *cash* position to become drastically worse as his sales increased.

It is obvious that the partnership would have made more profit if it had been able to retain the notes and contracts received from the purchasers of its trailers. If it had been able thus to carry on its business, it could have then realized not only the profit on the sale of the

trailer, but the not inconsiderable amounts which flowed from the finance charges and other "extras" into the finance companies.

F. *Reply to Commissioner's Argument.*

"II. The administrative practice"

Although the Commissioner argues (pages 35-39) that the consistent administrative practice of the Internal Revenue Service "carries substantial weight," it is significant that he has never attempted to incorporate his statutory interpretation in the Treasury Regulations. If he had felt strongly that his interpretation was correct many years ago, petitioners submit that the Treasury Regulations would have been appropriately amended.

"III. The nature of the transactions"

On pages 52-57 of his brief, respondent argues that the disputed amounts should be currently accruable because, if the trailer purchasers default in their payments, the taxpayers will obtain an ultimate tax benefit through the satisfaction of their "other obligations to the finance companies." (R. 82; Respondent's Brief, 57.) Petitioners urge that this contention is not applicable to the "year of accrual" determination. Respondent cites no authority for a purported principle that an accrual basis taxpayer must *accrue* currently as income amounts to which he has only contingent claims in the taxable year, simply because in some future year he *may* be entitled to a loss or bad debt deduction or offset. Accrual basis accounting has never recognized such a rule and it is not believed that the decisions of this Court or the lower courts support this oblique contention. It is still the "right to receive" the income in question and no other concept that determines the year of inclusion. *Spring City Foundry Company* v. *Commissioner*, *supra*; *Dixie Pine Products Company* v. *Commissioner*, *supra*; *Security Flour Mills Co.* v. *Commissioner*, *supra*.

CONCLUSION

Since the right of the instant partnership to the withheld amounts, and credited finance charges, was contingent and unascertainable during the taxable period and since the partnership might never receive such amounts at any time, the amounts in question did not accrue during the taxable period and the decision of the Court of Appeals for the Seventh Circuit should be reversed.

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APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. • • •

• • • •

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [as amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule*:—The amount of all items of gross income shall be included in the gross income

for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 42.)

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

§ 39.41-1. *Computation of net income.* Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See §§ 39.42-1 to 39.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

§ 39.41-2. *Bases of computation and changes in accounting methods.* (a) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall

be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. (See §§ 39.42-2 and 39.42-3.) On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. (But see § 39.22(c)-5.)

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In the
Supreme Court of the United States

OCTOBER TERM, 1958

No. 380

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

vs.

JOHN R. HANSEN and SHIRLEY G. HANSEN, *Respondents*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENTS

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BRIEF FOR THE RESPONDENTS

OPINIONS BELOW

The findings of fact and memorandum opinion of the Tax Court are not officially reported, but appear in the record (Hansen R. 60-68). The opinion of the Court of Appeals for the Ninth Circuit (H.R. 86-94) is reported at 258 F.2d 585.

JURISDICTION

The judgment of the Court of Appeals was entered on August 4, 1958 (H.R. 95). Petition for writ of *certiorari* was filed on September 18, 1958, and was granted on November 10, 1958 (H.R. 96). The jurisdiction of this Court rests on 28 U.S.C. 1254.

QUESTION PRESENTED

Did finance fees withheld and controlled by General Motors Acceptance Corporation in a contingent liability

reserve, accrue as income to auto-dealer respondents in the year when the reserves were created by GMAC, or alternatively, in the year when released to respondents, if ever released at all?

STATUTES INVOLVED

Sections 22(a), 41, and 42(a) of the Internal Revenue Code of 1939 are printed in the Appendix to this brief, at pages 23-24. Printed in the Appendix to the brief for the Commissioner, at pages 61-70, are the following: Rev. Rul. 57-2, 1957-1 Cum. Bull. 17; Treasury Regulations 111, Sections 29.41-1 and 29.41-2; and G.C.M. 9571.

STATEMENT

Respondents are husband and wife, residing in a community-property state, where the husband is a Buick dealer engaged in the business of selling automobiles at retail (Alleged, H. R. 10; Admitted, H. R. 26).

Respondents sell new autos upon conditional sales contracts (Admitted, H. R. 26). All of respondents' sales of autos on credit in 1951, 1952 and 1953, the tax years at issue, were made upon the same GMAC form of conditional sales contract, and all were financed by General Motors Acceptance Corporation (Stipulated, R. 6). The form of contract used was admitted into evidence as Joint Exhibit 5-E, and appears in the record at H. R. 39-40.

In the sales on credit by dealer Hansen, no promissory note or other commercial paper was executed by the retail purchaser to secure the conditional sales contract. The testimony of respondent (H. R. 29-34) and of Dallas L. Carter, his Certified Public Accountant (H. R. 34-38), on direct and cross-examination, makes no

reference to any note or commercial paper other than the conditional sales contract. There was none. Express evidence of non-existence is absent from the record because reference to "paper made payable to the dealer" and to "the note issued to the dealer" first appeared in the Hansen case in the Brief for the Commissioner filed in this court (Pages 42 and 47 (footnote 20)).

The conditional sales contracts were payable by the retail purchaser at the office of General Motors Acceptance Corporation (Joint Exhibit 5-E (8), at H. R. 39). Respondents in fact held none of the conditional sales contracts for financing by respondents, and financed none of them through any finance company other than GMAC (Stipulated, H. R. 6; H. R. 29).

The pattern of respondents' financing of credit sales was consistent—a single, three-party transaction. In each instance the retail purchaser signed the conditional sales contract furnished by GMAC and payable at its office, on the same form (R. 6, Joint Exhibit 5-E at H. R. 39); respondents assigned to GMAC by the form for assignment on the face of the contract; and delivered it to GMAC in return for money (H. R. 6, 35, Joint Exhibit 5-E at H. R. 39).

The course of dealing between respondents and GMAC required that a contingent liability reserve, called "Dealer's Reserve," be withheld by GMAC out of the finance charges (H. R. 30, 31, 35, 36). The purpose of the reserve was to protect GMAC from losses (H. R. 31).

When a retail purchaser prepaid his contract to GMAC, part of the financing cost had to be refunded to

him (H. R. 31). Losses from prepayment and losses from abnormal depreciation before repossessions, were chargeable to the reserve (H. R. 31). Losses chargeable to contingent liability reserve did occur, in the years at issue, due to prepayments and due to abnormal or accelerated depreciation before repossession (H. R. 31).

The reserve was withheld and controlled completely by GMAC (H. R. 32). Respondents could not draw upon the contingent liability reserve at will; could not borrow against it; and had no right to any of the reserve until released by GMAC (H. R. 32, 38). The reserve withheld, in the three years at issue, was required to exceed five per cent of total outstanding conditional sales contract balances for respondents' retail purchasers, before any reserve could be released (H. R. 31). Only the excess over five per cent was released by GMAC, and not the five per cent withheld (H. R. 31).

Release of any reserve was contingent upon there being in the reserve an excess over five per cent of outstanding contracts (H. R. 31), at an annual date in January of February (H. R. 33), pursuant to GMAC's "Retail Plan" (H. R. 86).

Respondents could have held their own contracts, assuming they had sufficient cash and if they had their own contracts made up (H. R. 33). In fact they held none (Stipulated, H. R. 6(3)). They could have financed with some other finance company; if they had the connection; which they didn't (H. R. 34).

Respondents took the payments released to them by GMAC when they could get them, and took all they could get (H. R. 33). All payments received by respond-

ents from GMAC, including funds released from contingent liability reserve, were reported as income in the years in which received (H. R. 33, 36, 37).

Respondents' accounting system was upon the accrual basis (H. R. 36). The computations for a credit sale are indicated on Joint Exhibit 5-E (H. R. 39): The total down payment, if any, was subtracted from the cash sale delivered price. To this was added the cost of required car insurance and any other charges, the sum being the principal balance. The principal balance was added to the finance charge, to reach the time (deferred) balance on the contract, which was payable by the retail purchaser at the office of GMAC in specified installments (Joint Exhibit 5-E, at H. R. 39). The total time price paid by the retail purchaser was the sum of his total down payment and his time (deferred) balance.

When GMAC set up a contingent liability reserve on its books, respondents could not get it, and could not draw upon it at will (H. R. 32). On respondents' books a memorandum account called "Due Finance Companies" was debited, and another called "Reserve for Repossession" was credited (H. R. 36). These were never taken into or deducted from income (H. R. 87). Respondents did not accrue and return as income the GMAC reserves in the year of sale of the car—the year the reserves were established (H. R. 86). When GMAC released any amount to respondents from the reserve, it was picked up in his income (H. R. 33, 36, 37, 87). The accountant for respondents testified that the described method of accounting treatment "is a generally accepted method of accounting which properly allocates the

income to the year in which it was earned, and I think it meets all the requirements of good accounting" (H. R. 36, 37).

Bad checks were charged off on respondents' books in connection with sales on open account of parts, accessories and repairs; but had nothing to do with the financing of sales of autos (H. R. 32, 37). No losses on GMAC reserves were charged to this account (H. R. 32, 37, 87).

Respondents followed a regular and consistent theory of accounting in 1951, 1952, and 1953, excepting only that all contingent liability reserves created by GMAC in 1952 were picked up as income in 1952 (H. R. 35). Refund was claimed (H. R. 9) and no estoppel has been asserted at any stage in this case.

The Commissioner determined deficiencies in income tax for respondents in 1951, 1952 and 1953, and certain civil penalties. After exhaustion of the procedure for administrative review, respondents filed Petition for Redetermination of Deficiency with the Tax Court of the United States, which entered decision upholding the Commissioner on August 1, 1957.

Upon petition for review, the United States Court of Appeals for the Ninth Circuit unanimously reversed the Tax Court, upon the contingent liability reserve issue, on August 4, 1958 (H. R. 86-95), by opinion reported at 258 F.2d 585. It affirmed upon a penalty issue not before this court.

SUMMARY OF ARGUMENT

Respondents' method of accounting clearly reflected income for tax purposes. Net income is computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer, unless the method employed does not clearly reflect the income. Int. Rev. Code (1939) sec. 41; Treas. Reg. 111, sec. 29.41-1, sec. 29.41-2. An accrual basis taxpayer must record income, and pay tax thereon, upon fixation of the right to receive income. *Spring City Foundry Co. v. Commissioner,* 292 U.S. 182, 184, 185. *North American Oil Consolidated v. Burnet,* 286 U.S. 417, 423-424. Respondents were upon the accrual basis.

Respondents accrued and declared reserve as income when their right to it became fixed—upon release and first availability to respondents.

There was no fixation of right to receive reserve for respondents, at date of sale of an auto. The reserve was an entry of unearned income on GMAC's books. Respondents had no legally enforceable right. GMAC held and controlled it. The reserve was subject to unilateral depletion by GMAC, to offset repossession losses and prepayment refunds. Only the excess over five per cent of outstanding contract balances for respondents' customers, if any excess, was available to the dealer, and that only once a year. The reserve was a contingent credit, not includible as income, like the patronage refund credit in *Long Poultry Farms, Inc. v. Commissioner,* 249 F.2d 726 (C.A. 4).

Actual receipt of income is not in issue, because respondents declared all they actually received when re-

ceived. There was no constructive receipt of income; because the concept of constructive receipt pertains to cash basis rather than to accrual basis, *Hansen v. Commissioner*, 258 F.2d 585, 587 (C. A. 9) (H. R. 86, 88); and because constructive receipt requires availability to the recipient so that it may be drawn upon at any time, and requires control and disposition of receipt, by the recipient. Treas. Reg. 118, sec. 39.42-2. Respondents had no control until release of the reserve. It was unavailable.

Respondents at no time acquired any account receivable in their own favor from the retail auto-purchaser. Aside from down payment (not in issue), the purchaser's only obligation was to GMAC. This is the significance of the single three-party transaction. By the single conditional sales contract (Joint Exhibit 5-E, H. R. 39-40), the dealer-respondents sold an auto; GMAC sold credit; and the retail purchaser bought both—by making a down payment to dealer and by contracting to make installment payments to GMAC. The installments included the finance charges from which the reserve was earned, month by month, over the term of the conditional sales contract. Purchasers' installments were payable at GMAC's office. The only consideration to dealer in the entire transaction (aside from the down payment not in issue) was from GMAC.

Petitioner's theory is "the two-transaction hypothesis," set forth at pages 41-52 of his brief. It does not fit the facts of the *Hansen* case, in reality or in substance. Circuit Judge Barnes, for the court below, called the theory of two separate sales "totally unrealistic" and

"an artificial characterization of the transaction * * *." *Hansen v. Commissioner*, 258 F.2d 585, 588 (C. A. 9) (H. R. 86, 89). GMAC was a necessary and patent party to every auto sale on credit by respondents, from the beginning of each sale. This was the factual reality, the substance, of each sale on credit.

Case authority directly in point strongly supports the unanimous decision below, in favor of respondents on the reserve question. The United States Courts of Appeals have held for the auto-dealer-taxpayer in each case where the facts established a single three-party transaction: *Hansen v. Commissioner*, 258 F.2d 585 (C. A. 9) cert. granted Nov. 10, 1958, No. 380, Oct. Term, 1958; *Glover v. Commissioner*, 253 F.2d 735 (C.A. 8) cert. granted Nov. 10, 1958, No. 381, Oct. Term, 1958; *Blaine Johnson v. Commissioner*, 233 F.2d 952 (C.A. 4); *Texas Trailercoach, Inc. v. Commissioner*, 252 F.2d 395 (C.A. 5); *West Pontiac, Inc. v. Commissioner*, 257 F.2d 810 (C.A. 5). Courts of Appeal decided in favor of the Commissioner in two cases where the facts were held to establish separate sales of auto and of account receivable. *Baird v. Commissioner*, 256 F.2d 918 (C.A. 7) cert. granted Nov. 12, 1958, No. 512, Oct. Term, 1958; *Schaeffer v. Commissioner*, 258 F.2d 861 (C.A. 6). Other citations to cases and to the periodical literature appear in respondents' main argument.

Petitioner errs in argument that reserves are taxable at creation because respondents ultimately would receive payments "either in cash or in the offset of their obligations to the finance companies" (Br. for Com. 32; 27). The "obligations" are contingent liabilities, not

presently in existence. Does the avoidance of a contingent liability, not yet incurred or fixed as a liability, constitute taxable income?

Petitioner argues the "re-enactment doctrine" at pages 23 and 39 of his brief. This point was never raised below, in the *Hansen* case, on the reserve issue; although it was raised on a civil penalty issue not before this court. Petitioner should be confined to points previously raised upon the issue at bar, in attacking the judgment below, upon *certiorari*.

ARGUMENT

I.

Respondents' Method of Accounting Clearly Reflected Income for Tax Purposes

A. The Method and the Issue

Respondents' regular method of accounting was to accrue and declare as income any payment they could get from GMAC's reserve, as soon as respondents could get it, but not before. Respondents accrued reserve into income—not when entries were set up on GMAC books at sale of car—but when excess of reserve over a required minimum, if any, was released and made available to respondents.

The issue is whether this method of accounting accurately reflected income for tax purposes. Did respondents have such a right to an unpaid sum as to require accrual of it as income when the car was sold and GMAC set up its entries?

B. The Statute

The Internal Revenue Code of 1939 governs computation of net income and of gross income:

"SEC. 41. GENERAL RULE.

"The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *." (26 U.S.C. 1952 ed., Sec. 41.)

"SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

"(a) General Rule.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *." (26 U.S.C. 1952 ed., Sec. 42.)

C. The Accounting Principle — Income Accrues Upon Fixation of Right to Receive

Two United States Supreme Court opinions, many years ago, established the basic tests which an accrual accounting system must pass in order clearly to reflect income. The case of *North American Oil Consolidated v. Commissioner*, 286 U.S. 417, 424, established the concept of income being reportable when the taxpayer receives earnings under a "claim of right":

"The net profits were not taxable to the company

as income of 1916. For the company was not required in 1916 to report as income an amount which it might never receive. * * * There was no constructive receipt of the profits by the company in that year, because at no time during the year was there a right in the company to demand that the receiver pay over the money. * * * Nor is it material, for the purposes of this case, whether the company's return was filed on the cash receipts and disbursements basis, or on the accrual basis. In neither event was it taxable in 1916 on account of income which it had not yet received and which it might never receive." *North American Oil Consolidated v. Commissioner,* 286 U.S. 417, 423-4.

This court has established that an accrual basis taxpayer must record income, and pay tax thereon, upon fixation of the right to receive income:

"Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrued." *Spring City Foundry Co. v. Commissioner,* 292 U.S. 182, 184.

D. Respondents Had No Fixed Right and No Claim of Right to Receive Reserve Until GMAC Released It

The plain fact is that the respondents had no fixed right and no claim of right—legal, contractual, or otherwise—to receive reserve until GMAC decided to release it. There could be no payment to petitioners at all unless the reserve exceeded 5 per cent of total outstanding contracts financed for petitioners; and then payment was limited to the excess, without invasion of the 5 per cent

reserved which the Commissioner would allocate to income.

There were substantial, concrete, restrictive conditions precedent. Any payment to petitioners was contingent upon an excess, which could result only if GMAC had favorable experience in collections upon the contracts from customers of petitioners. Favorable experience was uncertain, because losses from prepayments by auto purchasers were chargeable to the reserve, as were losses for abnormal depreciation before repossession. The testimony establishes that there always were such losses. Because of losses to be charged to the reserve, the ultimate receipts from it by petitioners were not determinable at the dates of creation of reserve.

As the court below pointed out:

> "The amount credited to the dealer's reserve is completely controlled by GMAC. It is true an amount is fixed, but this amount is subject to unilateral depletion by GMAC to offset repossession losses, prepayment refunds, and other charges determined by GMAC; the possibility of payment under this circumstance, although the maximum amount is determined, is so remote and contingent that it cannot be said to have become fixed and ascertained (*cf. Long Poultry Farms v. Comm'r*, 4 Cir., 1957, 249 F.2d 726, acquiesced in by the Commissioner, Rev. Rul. 57-358, 1958 P-H para. 54-503)." *Hansen v. Commissioner*, 258 F.2d 585, 589 (C.A. 9) H. R. 86, 90.

The record shows that respondents declared all actual receipt of income when received. That is undisputed. All payments by retail purchasers were made to GMAC,

and all payments made to respondents by GMAC were taken up and declared as received.

E. Respondents Had No Constructive Receipt

Respondents had no constructive receipt of the funds withheld in reserve by GMAC. As Circuit Judge Barnes, speaking for the Ninth Circuit, lucidly pointed out below:

> "Certain principles are appropriate for review. A cash basis taxpayer records income upon actual or constructive receipt—and it is well to note that constructive receipt means that the taxpayer has the present right to receive funds which he, for his own reasons, chooses not to exercise (Treas. Reg. 118, s. 39.42-2). An accrual basis taxpayer must record income, and pay tax thereon, upon fixation of the right to receive income, not upon its actual or constructive receipt." *Hansen v. Commissioner,* 258 F.2d 585 (C.A. 9) H. R. 86, 88.

Even if an accrual basis taxpayer had constructive receipt, respondents had none from the reserves while withheld. Treasury Reg. 118, sec. 39.42-2, sets forth the doctrine of constructive receipt. It provides that income may be taxed prior to the year of actual receipt although not then actually reduced to possession, if: (1) it is credited to the account or set apart for the taxpayer, and (2) it may be drawn upon by the taxpayer at any time.

> "To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be available to him so that it may be drawn at any time, and its

receipt brought within his own control and disposition * * * " Treas. Reg. 118, s. 39.42-2.

F. Each Sale of An Auto on Credit Was a Single Three-Party Transaction, to Which GMAC Was a Necessary Party

In substance the sale of an auto on credit was and had to be a single three-party transaction. Petitioners sold an auto, for trade-in and cash. GMAC sold the use of its money, for a finance charge. The purchaser bought both —the auto from the dealer, and the credit from the finance company. The finance charge was GMAC's price for the use of its money.

There had to be a finance company in each transaction, because the purchaser was unable to pay cash for the car. GMAC was a necessary party to every sale of an auto on credit. The absence of contractual requirement to finance sales through GMAC is immaterial, where practical business necessity caused every credit sale to be so financed.

The Sixth Circuit has said, in a different application:

> "And without regard to whether the result is imposition or relief from taxation, the courts have recognized that where the essential nature of a transaction is the acquisition of property, it will be viewed as a whole, and closely related steps will not be separated either at the instance of the taxpayer or the taxing authority." *Commissioner v. Ashland Oil & Refining Co.*, 99 F.2d 588, 591 (C.A. 6), cert. denied April 17, 1939.

In a different application, in *Helvering v. New Haven & Shore Line Ry. Co., Inc.*, 121 F.2d 985, 988, cert. denied Feb. 9, 1942, the Second Circuit said:

"As for the effort of the Commissioner to atomize the plan, as it were, *i.e.*, to separate it into its several steps and treat the last as though it stood alone, it has been repeatedly repudiated."

G. Retail Purchaser Incurred No Account Payable to Respondents: Respondents Acquired No Account Receivable

The single three-party transaction met practical business necessity by affording an ample and reliable source of credit. Its primary significance in the tax question before the court, however, is this: In each single three-party sale on credit, the retail purchaser's only obligation to pay, after his down payment not in issue, was an obligation to GMAC. The purchaser had to make his installment payments at the office of GMAC. Common sense dictates that the payments at GMAC's office were payments to GMAC, and nothing in the record indicates otherwise. Respondents at no time owned any account receivable from the retail auto-purchaser. The only consideration to respondents, aside from the original down payment not in issue, was from GMAC.

II.

Authority Strongly Supports the Unanimous Decision in Favor of Respondents Below

Case authority directly in point strongly supports the unanimous decision below, in favor of respondents on the reserve question. The United States Courts of Appeals have held for the auto-dealer-taxpayer in each case where the facts established a single three-party transaction. *Hansen v. Commissioner*, 258 F.2d 585 (C.A. 9) cert. granted Nov. 10, 1958, No. 380, Oct.

Term, 1958; *Glover v. Commissioner*, 253 F.2d 735 (C.A. 8), cert. granted Nov. 10, 1958, No. 381, Oct. Term, 1958; *Blaine Johnson v. Commissioner*, 233 F.2d 952 (C.A. 4); *Texas Trailercoach, Inc., v. Commissioner*, 251 F.2d 395 (C.A. 5); *West Pontiac, Inc., v. Commissioner*, 257 F.2d 810 (C.A. 5). Respondents will not belabor the Court with lengthy quotations from the decisions cited above, but will point out that the operative facts fit the present case and that the collective wisdom of the Courts of Appeals supports respondents herein. Two other decisions are distinguished here below.

Courts of Appeal decided in favor of the Commissioner in two cases where the facts were held to establish separate sales of auto and of account receivable. *Baird v. Commissioner*, 256 F.2d 918 (C.A. 7), cert. granted Nov. 12, 1958, No. 512, Oct. Term, 1958; *Schaeffer v. Commissioner*, 258 F.2d 861 (C.A. 6). In the *Baird* case it was stipulated that, in connection with the sale of trailers under conditional sales contracts, "the purchaser executed a note payable to the partnership for the unpaid price of the trailer, plus insurance, interest and financing charges" (Baird Record, 15). There was no promissory note in the Hansen case, and no instruments payable to the dealer. In *Baird* the Court of Appeals pointed out that "the partnership sold to either of two finance companies or a bank unpaid notes, chattel mortgages and conditional sales contracts." *Baird v. Commissioner*, 256 F.2d 918, 920 (C.A. 7); and again in footnote 9 at page 923, that no delinquencies were charged to the dealer's reserve accounts by any finance company, for the relevant years. Respondents Hansen, in the present case, uniformly dealt

with one finance company which was an original party to each sale on credit. Respondent Hansen sold no paper external to the conditional sales contract; upon the conditional sales contract, GMAC was in practical operation the payee. Losses were charged to the dealer's reserve in the Hansen case.

In the *Schaeffer* case, again the court found two separate transactions. By sale of car to purchaser, for a note and contract, dealer acquired an asset in the nature of an account receivable, without contingency. As between dealer and purchaser, the entire amount of the contract obligation accrued to dealer. *Schaeffer v. Commissioner,* 258 F.2d 861, 865 (C.A. 6). These facts differ from those in the case at bar.

An article supports respondents' position with penetrating analysis. *Installment Dealers' Reserves,* Woolvin Patten and Brockman Adams, Taxes, The Tax Magazine, CCH, July, 1958, pp. 485-490, 532. A scholarly Comment by Robert A. Jacobs concludes: "Inasmuch as the dealer has employed accounting procedures which properly reflect income and has reported as income those amounts to which the right to receive has become fixed, there is no reason why the Supreme Court should overturn the holding of the Ninth Circuit." 34 New York Univ. Law Rev. 315, 323.

The reserve issue was decided in favor of taxpayer in *Keasbey & Mattison Co. v. United States,* 141 F.2d 163 (C.A. 3). Taxpayer was a manufacturer of asbestos products who arranged with a finance company to discount notes given by purchasers to retailers of its products. Under its contract with the finance company the

taxpayer guaranteed part of the notes. Part of the discount was to be retained by the finance company in a reserve account analogous to GMAC's reserve, to cover the guaranty. The Court unanimously held that the amount of the reserve was not income to the taxpayer so long as the right to any of it was uncertain. An issue similar in principle was decided in favor of taxpayer, in *Commissioner v. Cleveland Trinity Paving Co.*, 62 F.2d 85 (C.A. 6). The court held that under a paving contract, percentages retained to guarantee maintenance of pavement were taxable as income to the contractor in the years when the money was paid, rather than in the years when the contracts were completed except as to maintenance. The court noted "the further principle that the fact that the taxpayer kept its books in most respects upon the accrual basis does not require it to accrue that which is but contingently earned." *Commissioner v. Cleveland Trinity Paving Co.*, 62 F.2d 85 (C.A. 6). The Commissioner did not appeal.

III.

Basic Fallacies Appear in Petitioner's Argument

A. Avoidance of a Contingent Liabilty Does Not Constitute Income

Petitioner errs in argument that reserves are taxable at creation because respondents ultimately would receive payments "either in cash or in the offset of their obligations to the finance companies." (Br. for Com. 32; 27). The "obligations" are contingent liabilities, not presently in existence. Does the avoidance of a contingent liability, not yet incurred or fixed as a liability, constitute taxable income? No. If A guarantees or warrants

that B will pay C, and B pays C, has A received taxable income? Of course not.

B. All Cases Cannot Be Equated, But Must Be Decided Upon Their Facts

Petitioner's brief for the Commissioner is a consolidated brief. It argues three cases jointly; including one not consolidated for trial, *Baird v. Commissioner,* 256 F.2d 918 (C.A. 7), No. 512, Oct. Term, 1958, in which one the Commissioner appears as respondent and not as petitioner. Partly as a result, there is a recurrent attempt to equate the operative facts of all three cases. The rationale is that if the sale on credit in one case was two transactions (sale of a car and sale of commercial paper by dealer), the sale on credit in the other two cases must be two transactions as well. Petitioner's "two-transaction hypothesis" is set forth at pages 41-52 of his brief. It does not fit the facts of the *Hansen* case, in reality or in substance. Circuit Judge Barnes, for the court below, called the theory of two separate sales "totally unrealistic" and "an artificial characterization of the transaction * * *." *Hansen v. Commissioner,* 258 F.2d 585, 588 (C.A. 9) (H.R. 86, 89). GMAC was a necessary and patent party to every auto sale on credit by respondents, from the beginning of each such sale. This was the factual reality, the substance, of each sale on credit. The dealer's reserve cases cannot be equated, but must be decided in distinct categories set by the facts of the cases.

C. The "Re-Enactment Doctrine" Is a New Point Not Properly Before This Court

Petitioner argues the "re-enactment doctrine" at

pages 23-24 and 39 of his brief. This point was never raised below, in the present case, on the reserve issue; although it was raised on a civil penalty issue not before this Court. Petitioner should be confined to points previously raised upon the issue at bar, in attacking the judgment below, upon certiorari. In the petition for a writ of certiorari in the present case, there is not a word about the "re-enactment document." On certiorari to review a decision of the Court of Appeals, matters not relied upon as basis for the petition will not be considered. *Alice State Bank v. Houston Pasture Co.*, 247 U.S. 240.

If the Court should find the point to be properly before the Court—and respondents do not waive the objection—respondents would attack its probative effect, in the light of facts including economic development in industries affected; and would attack the weakness of the inference of legislative intent; and would argue that administrative practice as inferentially approved by Congress is approved (if at all) as qualified by ruling case law at the time; and respondents would cite pending House Resolution 4518 as expressive of legislative intent. But the point is not properly before the Court.

D. The Tax Court Rule: Commissioner's Practice

Petitioner's brief, at page 29, cites some twenty decisions of the Tax Court in favor of the Commissioner. As properly indicated, five have been reversed, three have been affirmed, and three are pending on appeal. Respondents admit that the Tax Court uniformly upholds the Commissioner in the contingent liability cases. Dealers have won reversals in the Fourth, Fifth, Eighth

and Ninth Circuits, but the Tax Court has yet to decide the reserve issue in favor of a dealer, excepting in 1941 in the case of *Ernest G. Beaudry,* 1941 P-H B.T.A. Memorandum Decisions, par. 41, 114. The Commissioner has declined to acquiesce. Rev. Rul. 57-2, 1957-1 Cum. Bull. 17.

This works injustice, because only the taxpayer who can pay the expense of appeal can prevail, and he only at considerable expense.

The Commissioner's position on the dealer reserve question, as set forth clearly in Rev. Rul. 57-2, 1957-1 Cum. Bull. 17, and in G.C.M. 9571, X-2 Cum. Bull. 153 (Brief for Com. 65-70), is based upon a two-sale concept which does not fit the facts of the present case.

CONCLUSION

For the reasons stated it is respectfully submitted that the judgment of the court below should be affirmed.

EMMETT E. MCINNIS, JR.
Attorney for Respondents John R. Hansen and Shirley G. Hansen.

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) General Definition.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits, and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) General Rule.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 42.)

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Nos. 380, 381, and 512

In the

Supreme Court of the United States

OCTOBER TERM, 1958

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

JOHN R. HANSEN AND SHIRLEY G. HANSEN,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

BURL P. GLOVER,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

CLIFTON E. BAIRD AND VIOLET L. BAIRD,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF FOR THE AMICUS CURIAE, NATIONAL AUTOMOBILE DEALERS ASSOCIATION IN SUPPORT OF TAXPAYER

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On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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AMICUS CURIAE BRIEF OF NATIONAL AUTOMOBILE DEALERS ASSOCIATION

To the Honorable Chief Justice and Judges of the Supreme Court of the United States:

NOW COMES the National Automobile Dealers Association and with permission of the respective counsel of record first obtained, files herein its Amicus Curiae Brief in support of the taxpayer's position in connection with

the above cases, namely, John R. Hansen and Shirley G. Hansen, Burl P. Glover, and Clifton E. Baird and Violet L. Baird.

Since this is an Amicus Curiae Brief, references to the "Opinions Below" and "Jurisdiction" are not necessary.

QUESTION PRESENTED

Whether a taxpayer on an accrual basis, is liable for taxes for an amount set up by a finance company, being a portion of the finance charge, when such credit is contingent and the finance company admits no liability to the taxpayer for such credit.

STATUTE AND OTHER AUTHORITIES INVOLVED

In addition to the statutes and regulations quoted in the brief by the Commissioner, there is also incorporated in this brief Internal Revenue Regulations Section 1.446-1, Section 29.41-3, and Legal Opinion 1086 I-1 C. B. 87. (Appendix, page 19 to 20.

STATEMENT

Being in the position of amicus curiae, it wishes to state that the facts, of course, vary in each particular case, but fundamentally the proposition involved is the question of liability of a taxpayer on an accrual basis to pay taxes on an account carved out of the finance charges and carried by the finance company on its books and known as "dealer's reserves." The transactions involved start when a purchaser is desirous of purchasing an automobile, trailer

or other chattel on an installment basis and approaches a dealer to purchase the same. The dealer has a contract with either one finance company or several finance companies whereby the finance company agrees to accept the notes of dealer's purchaser upon approval of the finance company of the credit of the purchaser at a specific rate of charge. It is further agreed that the finance company out of said finance charges sets aside a portion thereof in a contingent credit known as "dealer's reserves." This credit is subject to the following contingencies:

(a) It is not actually in existence at the time and it is merely a credit on the books of the finance company and will be paid sometime in the future over a period of twelve (12), twenty-four (24) or thirty-six (36) months as the purchaser makes his monthly payment to the finance company. If the purchaser defaults after the first month, of course, the credit then would not be in existence or ever come into existence.

(b) It is subject to being reduced by the fact that the purchaser after paying over a period of several months defaults and the security (automobile, trailer or other chattel) is sold and the amount received for the sale of such security is insufficient to pay the debt due to the finance company—such difference is taken from this credit.

(c) This credit since it is a sum which is collectible over a period of twelve (12), twenty-four (24) or thirty-six (36) months but is set up immediately at the time the note is transferred, is also subject to being reduced by a prepayment on the part of the purchaser of the debt in full.

The transaction of the purchaser, dealer and the finance company is of necessity a simultaneous or three-cornered

transaction. After the price between the dealer and purchaser has been agreed upon, it is necessary for the finance company to approve the purchaser's credit before the transaction is completed. The forms are furnished by the finance company together with the purchaser's application for credit. When the finance company approves the purchaser's credit, the transaction is then completed by the down payment being paid by the purchaser and the execution of the notes by the purchaser. The notes are already made payable to the finance company, and thus the transaction is then completed with the assignment of the notes having been previously agreed upon by the finance company upon the approval of the credit of the purchaser. Upon receipt of the note or notes, as the case may be, the finance company makes an entry in its books crediting a certain portion of the finance charges to the dealer which is known as "dealer's reserve." This credit is not the obligation of the finance company but is really, in truth and in fact, the obligation of the purchaser as he makes his monthly payments over the period of the loan transaction. Thus being a portion of the finance charge it is construed to be interest and thus is collectible over a period of time and is a credit which the finance company admits no liability to the dealer until the dealer's reserve reaches a certain specified amount or the transaction has been completed by the purchaser paying for the security without any loss attendant thereto.

ARGUMENT

To represent to the Court in any manner that the transfer of the sale of the notes and the purchase of the property are two (2) separate transactions is, of course, not true as shown hereinabove. This Court on numerous occasions in approaching the principles of taxation has said that it looks at the substance of the transaction to determine what really occurred rather than the formality of the transaction.[1]

As was also said by Judge Wisdom in the case of *Texas Trailercoach v. Commissioner of Internal Revenue (5th Cir.), 251 F. 2d 395*, "* * * it is necessary to peel off the outer layer of the business transaction and get down to its core." In this case the Court, of course, held it was one transaction and logically so. The Courts have continually held in a similar situation where usury penalties were held to be recovered against the bank by the purchaser that it certainly constituted one transaction and not two transactions as contended by the Commissioner.[2] Of course, the fundamental problem is whether or not such entry on the books by the finance company constitutes accruable income to the taxpayer or dealer. Accruability of the income has been a rather troublesome problem through the years. As

[1] *Chamberlin v. Commissioner of Internal Revenue (6th Cir.), 207 F. 2d 462; Gregory v. Helvering, 293 U. S. 465, 55 S. Ct. 266, 79 L. Ed. 596; Minnesota Tea Co. v. Helvering, 302 U. S. 609, 58 S. Ct. 393, 82 L. Ed. 474; Higgins v. Smith, 308 U. S. 473, 60 S. Ct. 355, 84 L. Ed. 406; Commissioner of Internal Revenue v. Court Holding Co., 324 U. S. 331, 65 S. Ct. 707, 89 L. Ed. 981; Bazley v. Commissioner, 331 U. S. 737, 67 S. Ct. 1489, 91 L. Ed. 1782; Tennessee, Alabama & G. Ry. Co. v. Commissioner, 6 Cir., 187 F. 2d 826.*

[2] *First National Bank of Birmingham v. Daniel (5th Cir.), 239 F. 2d 801, 227 F. 2d 353 and 228 F. 2d 803.*

stated by Judge Hutcheson in *Frost Lumber Industries v. Commissioner of Internal Revenue (5th Cir.), 128 F. 2d 693*, "* * * we are reminded of Captain Cuttle's famous dictum, 'the bearings of that observation lies in the application of it.' * * *" Or the result being that the Commissioner construes it to the benefit of the Government without regard to the facts. *Mertens Law of Federal Income Taxation, Volume 2, Section 12.60, Page 127*, says as follows:

> "Accrual contemplates (1) an existing valid liability of the debtor or payor, (2) a reasonable fixing or determination of the amount of the liability, and (3) a reasonable degree of collectibility. There must be no contingency or unreasonable uncertainty qualifying the payment or receipt, as the case may be."

The Commissioner's contention it appears, therefore, falls down in all three instances. In the first place, there is no valid liability of the debtor or payor, as the finance company has no liability to the dealer, for such dealer's reserve account until it has exceeded a certain stated percentage, which is not in question here. The liability, if any, is on the purchaser of the automobile and his liability is only to that certain percentage of the finance charge which is paid monthly over a period of time. The so-called dealer's reserve credit is made immediately upon receipt of the notes by the finance company.

In the second place, there is no reasonable fixing or determination of the amount of the liability. This is true because it is a contingent fund which is subject to being

collected, in the first place, and depleted in the second place, by losses where the security does not satisfy the obligation.

In the third place, there is no reasonable degree of collectibility as it is an obligation that is uncollectible. The finance company admits no liability to the dealer for this amount and it certainly could not be sued upon and collected in any Court of Law. All of the Court decisions except the Tax Court up until the *Baird* and *Schaeffer* cases[3] recognized that reserves are not taxable.[4]

Certainly all of such Courts had some basis to justify their decisions. Which Courts, therefore, have taken the sounder viewpoint in this regard?

It is our position that a mere bookkeeping entry by a finance company does not constitute accruable income. Nothing has been received. As stated by the Supreme Court in *U. S. v. Safety Car Heating and Lighting Company, 287 U. S. 88, 56 S. Ct. 353 (1953):*

> "* * * No doubt the income thus accrued derived sustenance and value from the soil of past events. We do not identify the seed with the fruit that it will yield.

[3]*Baird v. Commissioner (7th Cir.), 256 F. 2d 918* and *Schaeffer v. Commissioner of Internal Revenue (6th Cir.), 258 F. 2d 861.*

[4]*Hansen v. Commissioner of Internal Revenue (9th Cir.), 258 F. 2d 585; Glover v. Commissioner (8th Cir.), 1958, 253 F. 2d 735; West Pontiac v. Commissioner (5th Cir.) 1958, 257 F. 2d 810; Texas Trailercoach v. Commissioner (5th Cir.) 1958, 251 F. 2d 395; Johnson v. Commissioner (4th Cir.), 233 F. 2d 952; Modern Olds v. United States (5th Cir.), D.C.N.D. Tex. 1957; Hine Pontiac v. United States (5th Cir.), D.C.N.D. Tex. 1957; Massey Motors v. United States (D.C.S.D. Fla. 1957), 156 F. Supp. 516; Marine Chevrolet Co., Inc. v. United States (D.C. 1958), 161 F. Supp. 62. Keasby & Mattison v. United States (3rd Cir.), 141 F. 2d 163; Commissioner v. Cleveland Trinidad Paving Co. (6th Cir. 1932), 62 F. 2d 85; Kilborn v. Commissioner (5th Cir.), 29 T.C. 102.*

> "Income within the meaning of the Sixteenth Amendment is the fruit that is born of capital, not the potency of fruition. With few exceptions, if any, it is income as the word is known in the common speech of men. Lynch v. Hornsby, supra, p. 344. When it is that, it may be taxed, though it was in the making long before. MacLaughlin v. Alliance Inc. Co., supra, at p. 249, 250; Taft v. Bowers, 278 U. S. 470; Helvering v. Canfield, supra, Cf. Lucas v. Alexander, 279 U. S. 573, 577, 578, Towne v. Eisner, 245 U. S. 418; Eisner v. Macomber, 252 U. S. 189, 206, 207."

The item of dealer's reserve is created by a contract between the finance company and the dealer. The contract provides that the credit is contingent, that it is subject to being depleted by losses and that the finance company has no obligation to pay that credit until the happening of certain events. Liability under contract for credit so created has been continually held by the Courts as not taxable through a long line of decisions. In the case of *Charlotte Union Bus Station v. Commissioner of Internal Revenue (4th Cir.), 209 F. 2d 586*, the Commissioner sought to assess the bus company for certain deficiencies but the Court held that the matters were controlled by the contracts between the parties, and said:

> "The government must assess taxes upon income which the taxpayer has received or which he has a fixed right to receive under existing contracts. Spring City Foundry Co. v. Com'r, 292 U. S. 182, 54 S. Ct. 644, 78 L. Ed. 1200. There is no basis in law or in reason for permitting the government, in order to tax non-existent income, to invoke the statute of frauds and repudiate, on the basis of the statute, contracts which a taxpayer has made in good faith and under which he has surrendered the right to receive the income which it is proposed to tax."

Furthermore, in the case of *Daley v. United States (9th Cir.), 243 F. 2d 466*, the Court in dealing with "holdbacks" held that such "holdbacks" under contracts were not accruable until paid and said:

> "With respect to the Delta Contract, the items of income consisted of the partial progress payments paid at the end of each calendar month upon approved estimates and ten per cent 'holdbacks' from those progress payments, paid upon completion and acceptance of all the work done under the contract. Under an accrual accounting method, the partial progress payments would accrue in the year when the right to receive the payments ripened with certainty. The remainder of the contract price would not accrue until the completion and acceptance of the contract. Costs would be apportioned over the contract price, and the costs applicable to the income accrued at the end of 1942 would be deducted in that year. Accord, U. S. v. Anderson, 269 U. S. 422, 46 S. Ct. 131, 70 L. Ed. 347; see Wagman, Tax Accounting for Long-Term Contracts, 33 Taxes 277."

In the case of *United States v. Harmon (10th Cir.), 205 F. 2d 919*, in a similar situation that Court said as follows:

> "It is the right to receive and not the actual receipt of income that determines when income must be included in gross income for income tax purposes. When the right to receive income becomes fixed and absolute, the duty of one on the accrual basis to report it arises.
>
> "Measured by this standard, it cannot be said that during 1943 Harmon's right to receive a definite, certain amount of the retained fee had become fixed and final. At the end of 1943, Harmon's interest in the retained portion of the fixed fee was subject to proper set-offs and deductions, if any, which might be revealed by the final audits. A number of things remained to be done upon which the determination of

that amount depended. The audits had not been completed. The outstanding claims had not been paid. Harmon's right to be credited with all these claims had not been finally determined. These matters were not determined until in 1944 and until that was done Harmon's interest in the amount of the fixed fee remaining in the Government's hands was not established with finality and certainty."

The most recent case upon a somewhat similar situation on this point is *Barham v. United States (4th Cir.), 256 F. 2d 456*, where the taxpayer received in a rather unique situation shares of stock in a building and loan association as part of the purchase price. The shares of stock had no market value and the Court held that the amount represented by said shares of stock was not accruable at the time they were received, because they had no market value and there was a contingency in connection therewith, and said:

"Until the right to an amount becomes accruable through fixation of the right to receive, the taxpayer is under no obligation to return it as income. Otherwise, he would be required to pay a tax on income which he might never have a right to receive. North American Oil Consolidated v. Burnet, 286 U. S. 417, 423-424, 52 S. Ct. 613, 76 L. Ed. 1197.

"* * *

"While it is true that taxpayers had an equity in the hypothecated shares, which they could sell if they could find a purchaser, that equity had no market value and was subject to such contingencies that as a practical matter it had no value for tax purposes. The fact that taxpayers received dividends on the shares is not controlling.

"* * * We agree with the test stated in Hudson v. Commissioner, 11 T. C. 1042, 1050, affirmed per

curiam 6 Cir., 183 F. 2d 180, also relied on by the government, that to avoid accrual taxpayers 'would have to prove that * * * some contingency or reasonable uncertainty about the ultimate payment was known to exist.' There was such contingency and uncertainty in the instant case."

In a similar situation, the Court has recognized that oil payments received for drilling by an accrual basis drilling contractor were not taxable until received and in the case of *Commissioner v. Edwards Drilling Company (5th Cir. 1938), 95 F. 2d 719*, said:

"It is of course true, as the Board points out, that under the accrual method of accounting employed by petitioner, items must be accrued as income when the events occur to fix the amount due and determine liability to pay. United States v. Anderson, 269 U. S. 422. Generally speaking, however, the income tax law is concerned, and its administration should deal only, with, realized losses, and realized gains. Lucas v. American Code Co., 280 U. S. 445. The taxpayer therefore, is under no obligation to pay a tax on income he might never receive. North American Oil Consolidated v. Burnet, 286 U. S. 417. A strained construction in administrative efforts to accrue income, should be avoided.

"Of the many cases supporting this view, Commr. v. Cleveland Trinidad Paving Co., 62 Fed. 2d 85; McPherson v. Helvering, 67 Fed. 2d 749, Burnet v. Logan, 283 U. S. 404; Woods v. Llewellyn, 252 Fed. 106, may be cited."

In the recent case of *Telephone Directory Advertising Company v. U. S. (Ct. of Claims), 142 F. Supp. 884*, the Commissioner assessed the corporation for future commissions which had not yet been earned when it was proved

that telephone advertising was indefinite and uncertain since it depended entirely upon the length of time that a particular directory would be in use. The Court in holding that such assessment by the Commissioner was improper, said:

> "In this case the Commissioner assessed the corporation for commissions which had not yet been earned, telephone advertising being indefinite because of the fact the advertising paid for month to month varied on how long that particular directory would be in use.
>
> "Under the well-settled annual accounting of revenues and expenses concept the Commissioner does not have the authority to allocate income to a taxable year other than the year in which a fixed right to receive a reasonable ascertainable amount exists. The Supreme Court in discussing the Commissioner's authority to shift income from one year to another stated in Security Flour Mills Co. v. Commissioner, 321 U. S. 281:
>
> "* * *
>
> " 'The uniform result has been denial both to the government and to the taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay has become final and definite in amount.' (321 U. S., pp. 286-287)."

It must be borne in mind at all times that the amount in question is actually a portion of the interest paid by the purchaser of the automobile, trailer or other chattel and that this interest payment is paid over a period of months or years. To assess taxes to a dealer for this interest before

it is paid is certainly in violation of all previous principles of law dealing with interest since it is normally income as it accrues.[5]

As stated in the case of *Chatham & Phoenix National Bank, 1 B. T. A. 460*, the Board of Tax Appeals said:

> "So much of the discount as was unearned within the year was therefore not a proper subject of accrual and the manner of accounting for discount went beyond either the cash or accrual basis and included as income within the year discount which was not income within the meaning of the law."

Furthermore, it was stated in the case of *Motors Securities Company, Inc., Tax Court Memorandum Decision (1952) P-H paragraph 52,316*, by the Tax Court as follows:

> "If, as respondent insists, the income resulted from a service charge, it was a service which covered the entire life of the paper, including as the record shows, requirements of receipt and collection of the installments due. See Linstedt-Hoffman Co., Supra. It would accordingly more clearly reflect income even on that approach for the payments to correspond to the expenses of acquisition and collection as the life of the note proceeded to its end. Southern Abstract & Loan Co. v. Commissioner (C. A. 6), 72 F. 2d 130."

The Commissioner in his brief concedes the logical basis and reasoning of the case of *Long Poultry Farms v. Commissioner of Internal Revenue (4th Cir.), 249 F. 2d 726*, but distinguishes it on the facts as it involves a cooperative. Certainly, no such distinction is justified since it deals fundamentally with the accruability or non-accruability of

[5] *American Bemberg Corporation v. United States (Dist. Ct. Del.), 150 F. Supp. 355.*

contingent income which is the same problem before this Court. It is also interesting to note that in this decision the Commissioner had similar rulings and regulations which he had strenuously relied upon in his brief but the Court in that case in discussing such regulations and the contingency of the income said as follows:

> "The Commissioner relies upon a regulation that he has adopted which accords with his contention in this case [Treasury Regulations 118 Sec. 3922 (a) 23]; but to the extent that this regulation is contrary to existing law or attempts to tax as income what is not income under law, it is, of course, void and of no effect. To require the inclusion in income of contingent credits such as are here involved, would be to require the patrons of cooperatives to pay tax upon income which they have not received, over which they have been given no control and which they may never receive."

It must be continually borne in mind that the obligation, if any there exists, is not upon the part of the finance company, but is solely on the part of the purchaser who is paying the monthly payments in discharge of the note. The finance company admits no liability to the dealer for the dealer's reserve. Obviously, therefore, the right to receive[6] cannot become fixed prior to the time the payor becomes obligated to pay.[7]

Finally, it would appear that some consideration should be given to the taxpayer's standpoint in this instance. Judge Hutcheson in the *Frost* case[8] after noting the

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[5] *Spring City Foundry Company v. Commissioner, 292 U. S. 182, 54 S. Ct. 644, 78 L. Ed. 1200.*

[6] *R. H. McDonald, Tax Court Memorandum Opinion, Docket 35526 (August 31, 1953).*

[7] *Frost Lumber Industries, Inc. v. Commissioner, 128 F. 2d 693 (5th Cir. 1942).*

dilemma of a taxpayer as to what is accruable and what is not accruable, said:

> "We are told that the test whether an item of income or of loss is sustained in a certain year is a practical one, but when we see the different results different supposedly practical men get from applying the same test, we plainly see that what to one practical mind seems heresy, to another equally practical, seems doctrine. In this situation of every mind for itself the solution, we think, is the preferred one which 'in case of doubt gives the benefit to the taxpayer,' another rule modernly more often honored in the breach than in the observance."

This is also true of Judge Wisdom's statements in the *Texas Trailercoach* case[9] in which he said as follows:

> "The closer a tax comes to giving effect to the economic realities, the more bearable it is as the price of national security and of civilization. The real trouble in this case is that the taxpayer is asked to pay a tax on money he did not in fact receive and had no right to receive during the taxable year in question. He may never receive it, but he is asked to deplete his cash in order to pay it. If compelled to pay, the more business he does—the worse off his cash position will be. But, if a more realistic view is taken, the Government will not be deprived of any tax, because when the contingent credit materializes as a fixed ascertainable claim or if payments are received from the reserve account, the taxpayer must then include the fixed claim or payments in his taxable income."

This is only saying again what Judge Atwell said in the *Hine Pontiac* case:[10]

> "It is the soul and life blood of a tax against the citizen that the citizen should have received something which justifies that tax."

[9] *Texas Trailercoach v. Commissioner (5th Cir.) 1958, 251 F. 2d 395.*
[10] *Hine Pontiac v. United States (5th Cir.), 1 AFTR 2d 58-734.*

CONCLUSION

It would appear therefore, that the mere bookkeeping entry credit by a finance company which admits no liability to the dealer for said credit entry, and which credit entry is interest to be collected over a period of time, and is also subject to being used to offset losses of the finance company on the security, could not in any manner be considered as accruable income. Accordingly, the decisions of the *Hansen v. Commissioner of Internal Revenue* and *Burl P. Glover v. Commissioner of Internal Revenue* cases should be in all respects affirmed, and the decision in the *Baird v. Commissioner of Internal Revenue* case should be reversed and rendered.

Respectfully submitted,

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By .....

CERTIFICATE OF SERVICE

Amicus Curiae, National Automobile Dealers Association, served three copies of Brief for the Amicus Curiae in Support of Taxpayer, in accordance with Rule 33, Subsections 1 and 3 (b), by depositing copies of the Brief in the United States Post Office at Washington, D. C., postage prepaid, addressed to Counsel of Record for Commissioner of Internal Revenue, J. Lee Rankin, Solicitor General, Department of Justice, Washington 25, D. C.

JAMES C. MOORE,
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APPENDIX

INTERNAL REVENUE CODE OF 1954:

SECTION 1.446-1 GENERAL RULE FOR METHODS OF ACCOUNTING. PROPOSED REGULATIONS, METHODS OF ACCOUNTING.

"(2) Accrual Method—Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year. For example, a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the produce is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method regularly employed in keeping his books. Likewise the extent to which indirect costs shall be included in computing costs of goods sold depends upon the method used by the taxpayer in treating such items in keeping his books."

INCOME TAX REGULATIONS:

"Section 29.41-3. Method of accounting.—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and

systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting methods as will enable him to do so."

LEGAL OPINION 1086 I-1 C. B. 87:

"* * * in order to be accruable in the taxable year for which a return is made, a valid right to income must have arisen or existed in that year, which is enforceable on the date the income is due. If, however, the right to an amount is contingent upon the happening of some future event, there is no certainty that it will be paid or will accrue. In the event no income accrued from a fixed and determinable source, and no right to anything arises or exists in the taxable year which can be accounted for as income under any system of accounting."

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Nos. 380, 381 and 512

IN THE

Supreme Court of the United States

OCTOBER TERM, 1958

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

JOHN R. HANSEN and SHIRLEY G. HANSEN

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

BURL P. GLOVER

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

CLIFTON E. BAIRD and VIOLET L. BAIRD, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

MOTION OF VANCE L. WILEY AND LUCILLE J. WILEY FOR LEAVE TO SUPPLEMENT THEIR BRIEF AS AMICI CURIAE

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On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

MOTION OF VANCE L. WILEY AND LUCILLE J. WILEY FOR LEAVE TO SUPPLEMENT THEIR BRIEF AS AMICI CURIAE

Vance L. Wiley and Lucille J. Wiley respectfully move the court for leave to supplement their brief as *amici curiae* (if motion to file same is granted) by filing copy of the opinion of the United States Court of Appeals for the Sixth Circuit, dated April 24, 1959, affirming the decision of the Tax Court of the United States in *Vance L. Wiley, et al.* v. *Commissioner*, T. C. Memo. 1957-236. The opinion is in the form of an order.

It is believed that this opinion is significant and should be considered by the Court, in the disposition of the instant cases, in connection with the contention of the Commissioner of Internal Revenue that "finance charges" are a part of the purchase price of an automobile or a trailer. In *Schaeffer* v. *Commissioner*, 258 F(2) 861, C.A. 6th, the court perhaps regarded the finance charges as part of the purchase price because they far exceeded the legal interest rate. In the *Wiley* case, on the other hand, it is undisputed that the finance charges from which the finance reserve was carved constituted true legal interest. Unearned interest to the date of maturity of the note (inadvertently referred to by the court as "prepaid interest") was included in the face amount of each note in addition to the unpaid balance of the purchase price of the trailer.

The *Wiley* decision, accordingly, presents directly this question: Whether a bookkeeping entry crediting the dealer with a part of the unearned interest charges constitutes income when the credit is made, even though the interest is not actually paid until later, and may never be paid if and to the extent that the note is prepaid.

For the convenience of the court the opinion of the Court of Appeals for the Sixth Circuit in the *Wiley* case is annexed hereto.

Respectfully submitted,

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Nos. 13,737-13,738

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 13,737

VANCE L. WILEY, ET AL., *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

No. 13,738

FRANK D. WILEY, ET AL., *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

Order

Filed April 24, 1959
Carl W. Reuss, Clerk

BEFORE: MARTIN, Chief Judge, MILLER, Circuit Judge, and BOYD, District Judge.

In *Schaeffer* v. *Commissioner*, 258 F(2) 861, C.A. 6th, we held that certain "hold-backs" by a finance company from the proceeds of a note executed by the purchaser of an automobile to the automobile dealer and sold by the dealer to the finance company, which "hold-backs" were credited in a dealer's reserve account on the books of the finance company, constituted accrued income to the dealer, who made return of income on the accrual basis, at the time of the transaction. The petitions for review of decisions of the Tax Court, which are now before us,

present the same basic question and are controlled by our ruling in the *Schaeffer* case unless there is some material factual difference between that case and the present ones.

Petitioners urge upon us as a distinguishing feature the following fact. In the present case, the source of the dealer's reserve account set up on the books of the finance company represented an obligation on the part of the purchaser of the automobile-trailer to pay what is termed finance charges, but which were actually prepaid interest to the date of maturity of the note, *in addition* to the unpaid balance of the purchase price. This additional amount was included in the note executed by the purchaser of the trailer to the automobile dealer and sold by the dealer to the finance company. If the note was paid before maturity only the portion of this amount earned at the time of payment, plus a penalty, would be actually paid and the finance company would debit the dealer's reserve account for such portion of the relieved charge. The Tax Court sustained the Commissioner's contention that this dealer's reserve account was accrued income to the dealer at the time it was entered on the books of the finance company. *Wiley* v. *Commissioner*, 26 P-H Memo. T.C., 1957-236.

Petitioners contend that this obligation of the purchaser was a contingent one; that the amount credited to the dealer's reserve account was merely a bookkeeping entry representing an unearned credit subject to a debit if the note was paid before maturity, with the result that the amount so debited was never earned and never received by the dealer; and that such bookkeeping entry could not be treated as accrued income to the dealer at the time the entry was made.

In our opinion, the factual difference is not sufficient to distinguish this case in principle from the ruling in the *Schaeffer* case. *Brown* v. *Helvering*, 291 U.S. 193,

200-201; *Heiner* v. *Melon*, 304 U.S. 271, 276; *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359; and cases cited by the Tax Court in its Memorandum Opinion.

IT IS ORDERED that the decisions of the Tax Court be affirmed.

Approved for entry:

s/ SHACKELFORD MILLER, JR.
United State Circuit Judge.